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Unlocking Long-Term Equity

For some time, the European Commission has been aware of the tension between its desire to see Europe's insurance industry be a long-term investor in the local real economy and the over-complex, variably interpreted capital relief rules for Long Term Equity under the Solvency II Directive. In December 2020, at the request of the Commission, Europe's insurance regulator, the European Insurance and Occupational pensions Authority (EIOPA), proposed some simplifications of those capital relief rules.

In this article, we assess the potential effect of these proposals on models of the balance sheets of a life insurer and a non-life insurer. We believe that the changes could enable insurers to invest in Long Term Equity while enhancing their solvency ratios and potentially improving the expected return on their Solvency Capital Requirements.

When the Solvency II Directive (Directive 2009/138/EC) first came into effect in 2016, the Standard Formula for calculating solvency capital placed a higher Solvency Capital Requirement (SCR) on investments in private equity relative to public equity. Private equity ("Type 2") was charged at 49% , on a par with hedge funds and emerging market equity, while developed market public equity ("Type 1") was charged at 39% (with monthly, counter-cyclical adjustments of up to +10% or -10% in line with the Symmetric Adjustment or "SA").

Since then, the European Commission has recognized that this treatment runs against the European Union's objective of sustainable long-term growth, and the importance to that objective of insurance industry investments in local private equity.

The Current Rules and Their Challenges

In a review of Solvency II in 2019, the Commission acknowledged that "Insurers have an important role as long-term investors and equity investments are important for the financing of the real economy," and this led to amendments to the Standard Formula under Regulation EU 2019-981. The intention was that Long-Term Equity (LTE), whether public or private, should benefit from a lower capital charge than even Type 1 public equity, subject to a set of quality criteria.

While the intent was welcomed by the insurance industry, some of the qualifying criteria were deemed difficult to implement and subject to wide interpretation. A summary of the main challenges is set out in figure 1.

FIGURE 1. TREATMENT OF EQUITY UNDER CURRENT SOLVENCY II RULES: ONGOING CHALLENGES

Asset Category	Solvency Capital Requirement	Qualifying Criteria	Resulting Challenges
Long-Term Equity (whether public or private or both)	22%, with no Symmetric Adjustment (SA)	• Investments and their holding period should be clearly identified • Average holding period exceeds five years • Must match a portfolio of clearly identified insurance or reinsurance obligations over their lifetime • Identified, managed and organised separately from the other activities of the undertaking • Cannot be used to cover losses arising from other activities • Portfolio (including portfolios held in vehicles such as a UCITS or AIF) consists only of equities that are listed in the European Economic Area (EEA) or of unlisted equity of companies with their head office in EEA countries • On an ongoing basis and under stressed conditions, able to avoid forced sales of each equity investment for at least 10 years • These qualifying criteria can be assessed at the fund level rather than the underlying asset level in the case of a UCITS or AIF	• The criteria are generally difficult for non-life insurers to meet • The criteria are interpreted as requiring "ring-fencing" of the qualifying assets • It is difficult to maintain the LTE assignment over the lifetime of the matched insurance obligations • Qualification may require a restructuring of the insurance obligations • It is difficult to define and test for qualification under the "forced selling" criterion
Qualifying Private Equity	39% + SA	• Portfolio companies (including those held in a vehicle such as an AIF) must be headquartered in the EEA, with >50% of revenues generated in the EEA or the OECD; and >50% of staff employed in the EEA • Additional requirements on turnover, concentration and a specific "Beta" parameter, described in Article 168a, reflect a blend of key financial statistics including gross margin, debt coverage ratio and return-on-common-equity	• U.S. companies are a majority component of many private equity portfolios • The "Beta" calculation is considered onerous and idiosyncratic
Equity Funds	39% + SA	39% SCR is applicable to several fund types, provided that the fund manager is authorised in the EEA: qualifying social entrepreneurship funds; qualifying venture capital funds; closed-ended and unleveraged alternative investment funds; or European long-term investment funds	• Insurers tend to use UCITS or separate accounts rather than these particular types of vehicle
Infrastructure equity	30% + 70%xSA for qualifying infrastructure equity; 36% + 92%xSA for qualifying infrastructure corporate equity	• To be considered as qualifying infrastructure equity, the investment must be directly into an infrastructure project that fulfils a set of stringent criteria • Qualifying infrastructure corporate equity refers to investments in the equity of corporate entities that undertake their own underlying investments in infrastructure projects, which face less restrictive criteria • Details are set out in Regulations EU 2016-467 and EU 2017-3673	• Insurers tend to invest in infrastructure debt rather than equity

Source: Neuberger Berman and EIOPA. For illustrative purposes only. This summary excludes strategic holdings and duration-based equities because these two categories represent a small universe of investments that would qualify to match insurance obligations; duration-based equities would be phased out under the new proposals for treatment of Long Term Equity.

EIOPA's New Proposals: Simpler and Less Restrictive

At the request of the European Commission, EIOPA has been reviewing various aspects of the Solvency II Directive, including the capital relief rules for Long Term Equity. In December 2020, it published its "Opinion on the 2020 Review of Solvency II" (EIOPA-BoS-20/749), which identified "issues concerning the possible restrictive interpretation of requirements related to the identification, management and organization of the LTE portfolios of assets and liabilities, which could be read to imply the need to establish ring-fenced funds in order to be compliant with the LTE requirements".[1] EIOPA has also recognized that the holding period qualifying criteria are overly strict when applied at the level of individual holdings.

To address these issues, the regulator has proposed some clarifications and simplifications to the qualifying criteria for Long-Term Equity, which is still to incur a solvency capital charge of 22% with no Symmetric Adjustment. While the proposed new rules would specify that a Long-Term Equity portfolio must be "well-diversified," the key requirement that the Long-Term Equity assignment must be maintained over the lifetime of the insurance obligations that they are matched against has been removed—and with it any implication that these assets need to be "ring-fenced" to qualify as Long-Term Equity. The rules would be further clarified for life insurers with a stipulation that the matched liabilities must have limited lapse risk and a duration of 10 years or more. Non-life insurers, which generally struggle to hold qualifying Long-Term Equity at all under the current rules, would be able to do so under the new proposals as long as they have a sufficient liquidity buffer to cover the investment, based on the High-Quality Liquid Assets criteria set out in the Basel III bank capital regulations.

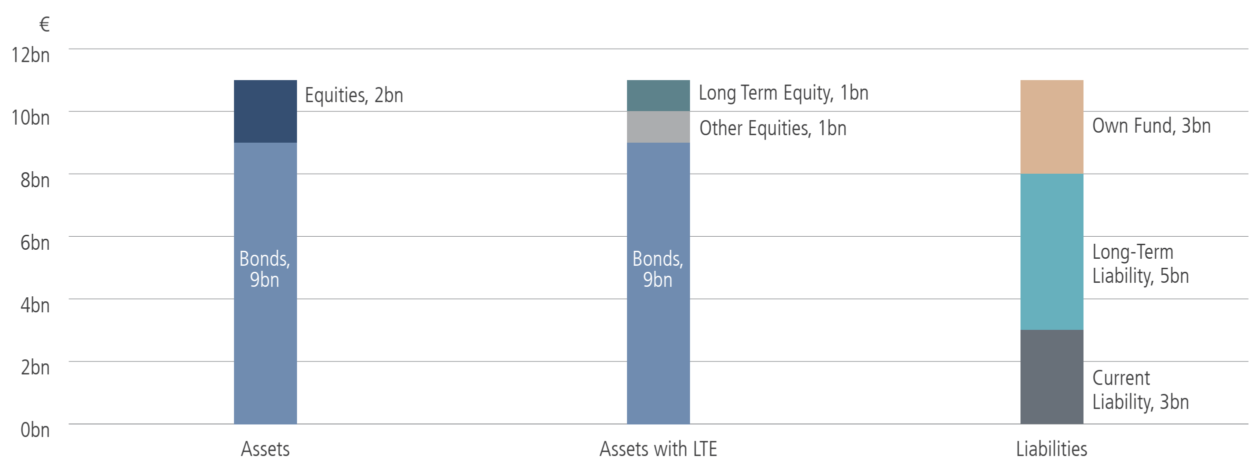
We think these proposals would make it significantly easier for both life and non-life insurers to incorporate Long Term Equity investments into their balance sheets. Alongside the 22% capital charge introduced in 2019, we believe this has the potential to enhance solvency ratios and improve expected returns on SCR.

Life Insurer Model: Long-Term Equity Under the Standard Formula

To illustrate this potential, we propose a simplified model of the typical conservative asset allocation of a European life insurer—with 82% in bonds and 18% in equities. This investor could construct a Long-Term Equity portfolio representing 9% of its assets, or half of its equity allocation, which currently has a SCR of 39%. This would be equivalent to just one fifth of its long-term liabilities—those with the longest duration and the lowest lapse, termination or surrender risk. The table in figure 2 shows the results under the Standard Formula, and reveals that, all else being equal, because of its lower SCR of 22%, the Long-Term Equity allocation adds 21 percentage points to the investor's solvency ratio.

FIGURE 2. LONG TERM EQUITY CAN SUBSTANTIALLY ENHANCE A LIFE INSURER'S SOLVENCY RATIO

Model life insurer's balance sheet, with and without Long Term Equity



Effect on Solvency Capital Requirement and Solvency Ratio of adding Long-Term Equity

	Equity SCR	Spread SCR	Base SCR	Solvency Ratio
Before LTE	€0.78bn	€0.90bn	€1.57bn	191%
After LTE	€0.61bn	€0.90bn	€1.42bn	212%

Source: Neuberger Berman, EIOPA. This simplified calculation assumes that all SCR comes from equity and spread risks; that spread risk SCR is on average 10% of the market exposure; and that there are no adjustments to capital positions for the loss-absorbing capacity of technical provisions, operational risks or other factors.

[1] Source: https://www.eiopa.europa.eu/content/opinion-2020-review-of-solvency-ii_en

Non-Life Insurer Model: Long-Term Equity Under the Standard Formula

For non-life insurers, the proposal is to allow a Long Term Equity allocation as long as there is a sufficient liquidity buffer to cover the investment, based on the Basel III High-Quality Liquid Assets criteria. This assessment applies a standard set of quality-based haircuts to available liquid assets, before comparing the results with liabilities.

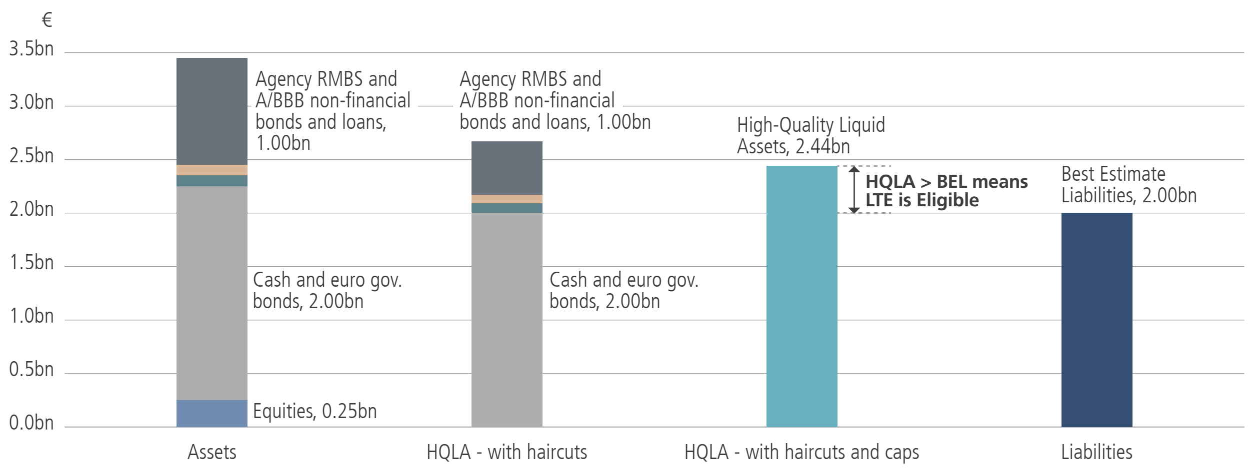
In figure 3, we apply EIOPA's proposed rules for assessing High-Quality Liquid Assets to a model balance sheet of a typical European non-life insurer. We see that the final value of the High-Quality Liquid Assets is greater than the insurer's liabilities, and it would therefore be allowed to construct a Long-Term Equity portfolio under the new proposals. We then calculate the change to the SCR and solvency ratio were the insurer to switch half of its €250m Type 1 Equity allocation into Long-Term Equity, and find that its SCR savings would be almost €20m out of its €3.4bn balance sheet.

FIGURE 3. CALCULATING LONG-TERM EQUITY ELIGIBILITY FOR A NON-LIFE INSURER

High Quality Liquid Assets assessment for the assets of a model non-life insurer

High-Quality Liquid Assets	Amount (€m)	HQLA treatment under the LTE rules	After Haircut (€m)
Cash and euro government bonds	2,000	Level 1, with no haircut	2,000
AAA/AA non-financial bonds and loans	100	Level 2A, with 15% haircut	85
AAA/AA covered bonds	100	Level 2B, with 25% haircut	75
Agency RMBS A/BBB non-financial bonds and loans	1,000	Level 2B, with 50% haircut	500
TOTAL HQLA	3,200		
TOTAL preliminary HQLA with haircuts	2,660		
TOTAL HQLA with haircuts and a 40% cap on L2A+L2B assets and a 15% cap on L2B assets	**2,438**		
TOTAL Best Estimate Liabilities	**2,000**		
Is an LTE portfolio eligible?	**YES**		

Model non-life insurer's balance sheet, showing High-Quality Liquid Asset value against liabilities



Effect on Solvency Capital Requirement and Solvency Ratio of adding Long-Term Equity

	Equity SCR	Spread SCR	Base SCR	Solvency Ratio
Before LTE	€0.098bn	€0.16bn	€0.242bn	599%
After LTE	€0.076bn	€0.16bn	€0.223bn	650%

Source: Neuberger Berman, EIOPA. This simplified calculation assumes that all SCR comes from equity and spread risks; that spread risk SCR is on average 5% of the market exposure of the bonds; and that there are no adjustments to capital positions for operational risks or other factors.

Conclusion: The Potential to Enhance Either Solvency Ratios or Expected Returns on SCR

By clarifying and simplifying the capital relief rules for Long-Term Equity under Solvency II, EIOPA's latest proposals should make it much easier for both life and non-life insurers to make qualifying Long-Term Equity allocations. Alongside the 22% capital charge introduced in 2019, which is substantially lower than the 39% applied to Type 1 developed market public equity, we believe this has the potential substantially to enhance solvency ratios.

Alternatively, insurers may choose to maintain their current solvency ratios and increase their equity allocation, via qualifying Long-Term Equity, thereby enhancing their expected return on SCR. Moreover, because Long-Term Equity can include suitably well-diversified private equity funds whose portfolio companies meet the EEA-headquarters criteria, cutting the SCR from 49% to 22%, expected return on SCR could be still further enhanced using private markets investments. Neuberger Berman manages private equity strategies and can build customized portfolios that we believe meet the qualifying criteria for treatment as Long-Term Equity.

We think the insurance industry should watch the European Commission's next steps carefully and start to think about how it can take advantage of these new proposals when they come into effect.

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