European Commission - Fact Sheet

Solvency II Overview – Frequently asked questions

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1. What is Solvency II?

The Solvency II regime introduces for the first time a harmonised, sound and robust prudential framework for insurance firms in the EU. It is based on the risk profile of each individual insurance company in order to promote comparability, transparency and competitiveness.

Solvency II (Directive 2009/138/EC) - as amended by Directive 2014/51/EU ('Omnibus II') - replaces 14 existing directives commonly known as 'Solvency I'.

2. Why was Solvency II necessary?

Over its 40 years of existence, the 'Solvency I' regime showed structural weaknesses. It was not risk-sensitive, and a number of key risks, including market, credit and operational risks were either not captured at all in capital requirements or were not properly taken into account in the one-model-fits-all approach. This lack of risk sensitivity had the following consequences:

- Owing to its simplistic model, Solvency I does not lead to an accurate assessment of each insurer's risks;
- It does not ensure accurate and timely intervention by supervisors;
- It does not entail an optimal allocation of capital, i.e. an allocation which is efficient in terms of risk and return for shareholders.

The Solvency II framework, like the Basel framework for banks, proposes to remedy these shortcomings. It is divided into three 'pillars':

- Pillar 1 sets out quantitative requirements, including the rules to value assets and liabilities (in particular, technical provisions), to calculate capital requirements and to identify eligible own funds to cover those requirements;
- Pillar 2 sets out requirements for risk management, governance, as well as the details of the supervisory process with competent authorities; this will ensure that the regulatory framework is combined with each undertaking's own risk-management system and informs business decisions;
- Pillar 3 addresses transparency, reporting to supervisory authorities and disclosure to the public, thereby enhancing market discipline and increasing comparability, leading to more competition.

Capital requirements under Solvency II will be forward-looking and economic, i.e. they will be tailored to the specific risks borne by each insurer, allowing an optimal allocation of capital across the EU. They will be defined along a two-step ladder, including the solvency capital requirements (SCR) and the minimum capital requirements (MCR)[1], in order to trigger proportionate and timely supervisory intervention.

The new regime will also eliminate existing restrictions imposed by Member States on the composition of insurers' investment portfolios. Instead, insurers will be free to invest according to the 'prudent person principle'[2] and capital requirements will depend on the actual risk of investments.

As for insurance groups, the same approach will be applied as for individual insurers so that groups will be recognised and managed as economic entities. In capital requirements, diversification benefits will be recognised, meaning that the total risks of a group are less than the sum of the risks of its entities. This will also contribute to a more efficient capital allocation for shareholders.

The new regime will also promote greater cooperation between national insurance supervisors that oversee the subsidiaries of any given group, with a stronger role for the group supervisor. The European Insurance and Occupational Pensions Authority (EIOPA) is tasked with ensuring that the single rule book is applied consistently throughout Europe. EIOPA also has mediating powers in case disagreements emerge between national supervisory authorities when supervising cross-border groups.

3. What does the Delegated Act (implementing rules) add to the Solvency II Directive?

The implementing rules contained in the delegated act which is due to enter into force on the day following publication in the Official Journal, aim to set out more detailed requirements for individual insurance undertakings as well as for groups, based on the provisions set out in the Solvency II Directive (see IP/14/1119). They will make up the core of the single prudential rulebook for insurance and reinsurance undertakings in the Union. They are based on a total of 76 empowerments[3] in the Solvency II Directive and in particular cover the following areas:

- rules for the market-consistent valuation of assets and liabilities, including technical provisions; in particular, the rules set out technical details of the so-called 'long-term guarantee measures' which were introduced by the Omnibus II Directive to smooth out artificial volatility and ensure that insurers can continue to provide long-term protection at an affordable price;
- rules for the eligibility of insurers' own fund items, covering capital requirements to improve the risk sensitivity of the regime and allow timely supervisory intervention;
- the methodology and calibration of the Minimum Capital Requirement (MCR) and of the standard formula for the calculation of the Solvency Capital Requirement (SCR); this includes the calibration of market risks on insurers' investments, taking into account the Commission's long-term financing agenda (see question 5);
- for undertakings applying to use an internal model to calculate their SCR, the implementing rules also specify standards that must be met as a condition for authorisation;
- the organisation of insurance and reinsurance undertakings' systems of governance, in particular the role of the key functions defined in the Directive (actuarial, risk management, compliance and internal audit); the implementing rules also specify some aspects of the supervisory review process and the elements to consider in deciding on an extension of the recovery period for undertakings that have breached their SCR;
- reporting and disclosure requirements, both to supervisors and to the public; the increased comparability and harmonisation of information is intended to improve the efficiency of supervision and foster market discipline;
- criteria for supervisory approval of the scope of the authorisation of special purpose vehicles taking on reinsurance risk, and requirements related to their operation;
- rules related to insurance groups, such as the methods for calculating the group solvency capital requirement, the operation of branches, coordination within supervisory colleges, etc.; and
- criteria to assess whether a solvency regime in a third country is equivalent.

4. When will the new rules become applicable? Are there transitional provisions?

The Solvency II Directive, along with the Omnibus II Directive (see MEMO/13/992) that amended it, will have to be transposed by Member States into national law before 31 March 2015. On 1 April 2015, a number of early approval processes will start, such as the approval process for insurers' internal models to calculate their Solvency Capital Requirement. The Solvency II regime will become fully applicable on 1 January 2016. This timeline – in parallel with EIOPA's set of guidelines on preparing for Solvency II – allows supervisors and undertakings to prepare for the application of the new regime.

In addition, Solvency II includes a number of measures to ensure a smooth transition from Solvency I, mostly:

- two measures on the valuation of technical provisions, helping the transition to a market-consistent regime over 16 years;
- tolerance for insurers breaching the Solvency Capital Requirement within the first two years;
- grandfathering of existing hybrid own-fund items that are eligible under Solvency I, making it easier to meet the new capital requirements and giving the industry 10 years to adapt the composition of its capital to Solvency II standards;
- longer deadlines to report quarterly and annual information to supervisors and to disclose reports to the public, decreasing gradually from 20 weeks to 14 weeks after the close of the reporting period over the first 3 financial years.

5. How do the implementing rules contribute to a proportionate application

of Solvency II, particularly for small and less complex insurers?

The principle of proportionality is an integral part of the Solvency II regime, meaning that a proportionate application of Solvency II should also apply to small and less complex undertakings.

Solvency II will apply to almost all insurers and reinsurance undertakings licensed in the EU. Only the smallest undertakings (typically, undertakings that are not part of a group and write less than EUR 5 million in premiums per year) will be exempt from the new rules, although they may choose to apply them if they wish. Small insurance undertakings play an important role in the economic environment and should not be subjected to unnecessary regulation.

Examples of proportionality lie mostly in the implementing measures (delegated act) and include:

- simplified methods for the calculation of technical provisions;
- simplified methods for the calculation of the capital requirement;
- asset-by-asset data is not required for collective investments; data may be grouped under certain conditions;
- exemptions are introduced from the use of International Financial Reporting Standards (IFRS) in the valuation of assets and liabilities for undertakings that do not already use IFRS for their financial statements;
- with respect to governance, key functions may be shared, including the internal audit function, in certain circumstances;
- with respect to reporting by smaller insurers:
- quarterly reporting is of core data only;
- supervisors can waive quarterly reporting partly or entirely, and some of the annual reporting for smaller undertakings;
- supervisors can decide to require narrative reporting only every three years (though it would normally be annually).

6. What does Solvency II do to stimulate long-term investment by insurers?

European insurers are the largest institutional investors in Europe's financial markets. It is crucial that prudential regulation should not unduly restrain insurers' appetite for long-term investments, while properly capturing the risks.

First, the capital requirements are designed to strongly incentivise insurers to match the duration of assets and liabilities. A perfect match in duration could reduce massively capital requirements[4]. Besides, on certain portfolios where cash-flows are matched and insurers can hold fixed-income assets to maturity, they may use the 'matching adjustment' which smoothes out artificial volatility on their balance sheet and significantly reduces the capital requirement corresponding to the risk of short-term spread fluctuations (see question 8). Therefore, the design of the capital requirements will increase insurers' appetite for long-term assets.

Second, Solvency II will repeal the investment limits imposed by Member States regarding certain investments, in particular less liquid ones such as infrastructure. Instead, insurers will be free to invest according to the 'prudent person principle' and capital requirements will depend on the actual risk of their investments. The standard formula for the calculation of market risk must be sufficiently detailed to cater for different asset classes, featuring different risk profiles.

More tailored treatment of these assets has the added advantage of increasing the risk-sensitivity of the capital requirements and thereby promoting good risk management and supporting the prudential robustness of the overall regime. The identification of a high-quality category of securitisation based on the criteria set out in the European Insurance and Occupational Pensions Authority (EIOPA)'s advice on high-quality securitisation from December 2013) is significant in this respect. It will encourage insurers to invest in simpler securitisations, which are more transparent and standardised, thereby reducing complexity and risk and promoting sound securitisation markets which are needed in the EU (see section below on securitisation).

Other specificities of the standard formula to stimulate long-term investment by insurers include:

- favourable treatment of certain types of investment fund that have been created recently under EU legislation, such as European Social Entrepreneurship Funds and European Venture Capital Funds. (Note: the European Long-Term Investment Fund Regulation was still under negotiation at the time of adoption of the Solvency II delegated act. It was therefore legally impossible to cater explicitly for ELTIF funds at the time of adoption of the implementing measures);
- similarly favourable treatment of investments in closed-ended, unleveraged alternative

investment funds, which captures in particular other private equity funds and infrastructure funds other than the European Funds mentioned above;

- investment in infrastructure project bonds are treated as corporate bonds, even when credit risk is tranched, instead of being treated as securitisations. This is aligned with their treatment under banking regulation (See recital (50) of Regulation (EU) No 575/2013 (the Capital Requirements Regulation (EU) No 575/2013) on prudential requirements for credit institutions and investment firms.);
- several measures focused on unrated bonds and loans (targeting in particular SMEs and infrastructure projects):

- insurers investing in unrated bonds and loans can use proxy ratings (e.g. using the rating of the issuer or of other debt instruments which are part of the same or similar issuing programmes). The same provisions exist in banking regulation (see article 139 of the Capital Requirements Regulation (EU) No 575/2013) and help to reduce overreliance on ratings by avoiding punitive capital treatment for unrated instruments;
- where unrated debt instruments are guaranteed by collateral, the risk-mitigating effect of the collateral on spread risk is recognised;
- where debt instruments are fully guaranteed by multilateral development banks, such as the European Investment Bank or the European Investment Fund, they are exempted from any capital requirement for spread and concentration risk, as is the case under banking regulation (see articles 117 and 235 of the Capital Requirements Regulation). The due diligence and credit enhancement provided by these two European bodies considerably reduce the risk of such investments.

7. What are the costs of implementing Solvency II?

- In terms of implementation costs, the one-off net cost of implementing Solvency II for the whole EU insurance industry has been assessed to be around EUR 3 billion to EUR 4 billion[5], which is relatively small compared to the annual turnover of the sector (around EUR 1.1 trillion of written premiums).
- In terms of capital requirements, taking into account the so-called 'long-term guarantees package' in the Omnibus II Directive[6], the aggregate available surplus (free own funds above the capital requirements of each insurer) is likely to be broadly identical to the aggregate situation under Solvency I. However, the distribution of capital requirements across undertakings will reflect more accurately individual risks, leading to a more efficient allocation of capital in the EU.

8. How is excessive volatility avoided in Solvency II?

- Under Solvency II, insurers are incentivised to match cash-flows with the long-term guarantees they offer using long-term assets available in the market (see question 6). This means they are less reliant on short-term price movements in their assets, where these are unrelated to default. It is therefore important to avoid artificial volatility in balance sheets, i.e. volatility of technical provisions, capital resources or capital requirements that does not reflect changes in the financial position or risk exposure of the insurers.

The so-called 'long-term guarantees' measures, introduced by Omnibus II, will mitigate this artificial volatility by partially reflecting movements in asset prices in the market-consistent valuation of the liabilities, thereby reducing artificial balance sheet volatility. By incorporating the long-term investment strategies of insurers in the market-consistent valuation framework, the long-term ability of insurers to meet their cash-flow needs is more accurately captured.

The measures contained in the package are essentially those proposed by EIOPA in its long-term guarantee assessment report of June 2013, with modifications to the detailed calibrations:

- **Volatility adjustment:** a volatility adjustmentto the discount rates[7] for calculating technical provisions aiming to avoid pro-cyclical investment behaviour of insurers when bond prices deteriorate owing to low liquidity of bond markets or exceptional expansion of credit spreads. The adjustment has the effect of stabilising the capital resources of insurers and will be calculated by EIOPA.
- **Matching adjustment:** a matching adjustment will adjust the discount rate applied in the valuation of predictable liabilities which are cash-flow matched using fixed income assets. The predictability of the portfolio means that matching assets can be held to maturity and that the insurer is consequently not exposed to price movements, only to the risk of default. The matching adjustment is symmetrical – it can be positive in times of high risk aversion in the markets and negative in times of low risk aversion.
- **Extrapolation:** Technical provisions are discounted with risk-free interest rates. The rates are

based on market observations. For long maturities where no reliable market data are available the risk-free interest rates need to be extrapolated. The purpose of extrapolation is to ensure that the valuation of technical provisions and the solvency postions of insurers are not heavily distorted by strong fluctuations in the short-term interest rate.

- **Two transitional measures:** these allow insurers, over 16 years, to:
  - o calculate their technical provisions by using the Solvency I discount rates, or
  - o calculate technical provisions according to Solvency I rules.

The transitional measures will only apply to technical provisions for insurance contracts concluded before the start of the Solvency II regime. The transitional measures are designed to phase out in a linear way over the transitional period. They are needed to smooth the transition to Solvency II for contracts concluded under the previous solvency regime, which might otherwise risk disturbing the insurance market.

- **Extension of the recovery period**: in the event of exceptional adverse situations, as determined by EIOPA, the supervisory authority may extend the maximum recovery period in order to re-establish compliance with the Solvency Capital Requirement. Exceptional adverse situations include falls in financial markets, persistently low interest rate environments and high-impact catastrophic events. The maximum extension is limited to 7 years. The extension of the recovery period is an element of the so-called 'ladder of intervention' which provides for intensified intervention by supervisors between the two levels of capital requirements – the solvency capital requirements and (SCR) and the Minimum Capital Requirement (MCR) – in order to ensure that corrective measures are taken sufficiently early.

9. How do capital charges compare with those applicable to banks under the Capital Requirements Regulation (CRR)/ Capital Requirements Directive IV (CRDIV)?

It is important to ensure as much consistency as possible across the whole financial sector to favour the development of a new and resilient investor base while avoiding arbitrage opportunities.

First, it is desirable that definitions of asset classes are as consistent as possible in different sectoral regulations. For instance, the definition of simpler, more transparent securitisations in Solvency II referred to in question 5 above is consistent with the definition set out in the implementing rules on banks' Liquidity Coverage Ratio (see MEMO/14/579).

Second, it is desirable that relative capital requirements on different asset classes are comparable across sectors, e.g. the relative ranking in terms of riskiness of equities versus corporate bonds should be as consistent as possible.

However, a strict alignment of capital requirements in banks and insurance would not be appropriate, as the risk measures are very different. Indeed, a direct comparison of the capital calibrations for market and credit risk is not meaningful for a number of reasons:

- Under Solvency II, capital requirements are determined on the basis of a 99.5% value-at-risk measure over one year, meaning that enough capital must be held to cover the market-consistent losses that may occur over the next year with a confidence level of 99.5%, resulting from changes in market values of assets held by insurers. By contrast, under CRR/CRDIV, the risk measure is a 99% value-at-risk measure over 10 days for the trading book[8], while risk weightings in the non-trading book capture credit risk, not market-consistent price fluctuations. The different risk measures applied mean that the resultant capital charges should in any event not be identical.
- In contrast to the risk weights applicable to the banking book, the risk factors in Solvency II do not translate directly into capital requirements. Risk factors in Solvency II are applied as stress scenarios on asset values, and the capital requirement is equal to the net impact on own funds, taking into account the entire balance sheet. Therefore:
- capital requirements in Solvency II depend on diversification between different sources of risk and the loss-absorbing effect of discretionary benefits and deferred taxes. These combined effects can reduce the capital charge resulting from the stress factors by about half.
- capital requirements in Solvency II depend on the liabilities of each undertaking. The better the asset proceeds match the liabilities of an undertaking in all the various stressed scenarios, the lower the final capital charge will be. An example of this is the interest rate stress, which is lowest when the timing of future asset and liability cash-flows are matched and remain matched under stress.

10. How will Solvency II ensure that European insurers can continue to be competitive abroad?

The Solvency II Directive includes equivalence provisions regarding third countries. When EU insurance groups calculate how their operations located in an equivalent third country contribute to the group-wide Solvency Capital Requirement, equivalence provisions allow them to use the third-country local rules intead of Solvency II rules, under certain conditions.

The implementing rules flesh out certain criteria for equivalence and elaborate on the choice of calculation methods for group solvency. They ensure that future equivalence decisions by the Commission will bring real benefits to EU insurance groups active abroad, maintaining a level playing field with foreign competitors.

Any decision on the equivalence of specific third-country regimes would be adopted later, in the form of further delegated acts, on the basis of detailed analysis of third country regimes by EIOPA.

11. Will the Solvency II regime be reviewed?

The Omnibus II Directive includes a review clause (recital 60) inviting the Comission to review the methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement (SCR) with the standard formula within five years of application of the new regime (i.e. by end 2021). A recital in the delegated act brings this review forward to the end of 2018. The review should make use of the experience gained in the first few years of application of Solvency II.

Besides, the Directive (in Article 77f) mandates the Commission to report to the co-legislators by the end of 2020 on the impact of the so-called "long-term guarantees" package, in particular the functioning and stability of European insurance markets; the extent to which insurance and reinsurance undertakings continue to operate as long-term investors; and the availability and pricing of long-term insurance products.

12. What are the different pieces of legislation in the Solvency II framework?

The Solvency II Directive (Directive 2009/138/EC), as amended by the Omnibus II Directive (Direction 2014/51/EC) sets out the basic principles of the regime. The Directive lays down many empowerments for the Commission to adopt delegated acts, and for the European Insurance and Occupation Pensions Authority (EIOPA) to draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS), in accordance with its founding regulation (Regulation (EU) No 1094/2010).

However, the co-legislators have provided for a 'sunrise clause' whereby the Commission is empowered, for two years following the entry into force of Omnibus II, to adopt the Regulatory Technical Standards in accordance with the procedure for the adoption of delegated acts, instead of the procedure set out in the EIOPA founding Regulation (see Recital (16) of the Omnibus II Directive and Article 308b). Therefore, the main delegated act is based on a total of 76 empowerments in the Solvency II Directive, including some which are in principle for EIOPA to develop draft RTS but fall within the scope of the 'sunrise clause'.

Pursuant to Article 16 of its founding Regulation, EIOPA can also issue guidelines with a view to establishing consistent, efficient and effective supervisory practices, and to ensuring the common, uniform and consistent application of EU law. Such guidelines are addressed to supervisors and undertakings and are not legally binding, but addressees not complying with them will have to explain their reasons.

HIGH QUALITY SECURITISATION

13. What are the specific provisions in the Solvency II delegated act?

Building on recommendations from the European Insurance and Occupational Pensions Authority (EIOPA), the Commission delegated act includes a detailed list of criteria to identify high-quality securitisation. These criteria are mainly related to i) the structural features of transactions, ii) underlying assets' characteristics, iii) transparency features and iv) underwriting processes. Insurance undertakings investing in these instruments will be required to hold less capital for market risk when they invest in securitisations that feature a high degree of simplicity, transparency and credit quality. This high-quality category would include the most senior tranches of securitisations backed (under a "true sale" mechanism) by residential mortgages, auto loans and leases, SME loans or consumer loans and credit card receivables, but excluding re-securitisations and synthetic securitisations.

Securitisation positions that meet the "high quality" requirements will attract significantly lower capital requirements for insurers, compared to other securitisation positions. Their treatment under the standard formula follows a look-through approach, whereby capital requirements on those positions cannot be higher that capital requirements on the underlying securitised exposures if they were held directly by insurers. Securitised exposures would typically be treated as unrated loans, attracting a 3%-per-year-of-duration stress in the standard formula. Therefore, risk factors applicable to high-quality securitisation positions are capped at 3%.

14. What is the prudential basis for the preferential treatment of high-quality securitisations under Solvency II?

Only the most senior tranches may qualify for the favourable capital treatment of high-quality securitisation positions. These senior tranches provide credit enhancement, in other words, their credit risk is lower than the credit risk in the entire pool of underlying exposures. It makes sense from an economic point of view that risk factors for high-quality senior securitisation positions are no higher than those applicable to the underlying securitised exposures if they were held directly by insurers.

15. What are the eligibility criteria in the Liquidity Coverage Ratio (LCR) and Solvency II delegated acts?

The criteria to identify highly transparent, simple and sound securitisation instruments set out in the Solvency II and LCR delegated acts are based on recommendations from the European Insurance and Occupational Pensions Authority (EIOPA) and a detailed analysis of the liquidity of different instruments from the European Banking Authority (EBA)[9]. In December 2013, the Commission received EIOPA's technical report on the design and calibration of the Solvency II standard formula for certain long-term investments. This report proposed to single out high-quality securitisation and to apply a differentiated prudential treatment to them.

In addition, the European Central Bank and the Bank of England supported this differentiation objective in a joint statement released in April 2014 and in a discussion paper published in May 2014.

The European Parliament, too, has expressed its support for the development of high-quality securitisation instruments in its Resolution on long-term financing.

The proposed criteria to identify high-quality securitisations do not include any risk retention requirements (i.e. requirements that the originator, sponsor or original lender should retain a material net economic interest in the transaction). This is because risk retention requirements are already implemented in EU law and apply across the board, to all types of securitisation instruments (whether high-quality or not) held by insurance undertakings[10] and credit institutions[11].

Most criteria on high-quality securitisation are common to the Solvency II and LCR delegated acts. However, as the purpose is different in each act – the Solvency II standard formula concerns capital requirements, while the LCR delegated act prescribes rules for the assets held by banks in their liquidity buffer – some criteria are specific to the LCR delegated act, to ensure that high-quality securitisation instruments are also highly liquid.

15.1. General Requirements

15.1.1. Maximum seniority

The tranche must be the most senior in the securitisation transaction, and it must remain so at all times, even after events that may impact the relative seniority of tranches, such as the delivery of an enforcement or acceleration notice. This criterion ensures that the credit quality of the tranche is indeed enhanced as compared to the credit quality of the entire pool of underlying exposures. Maximum seniority is among the more relevant features justifying a prudential treatment that is aligned to the underlying exposures.

15.1.2. Homogeneous eligible underlying exposures

Homogeneity in the type of underlying exposures increases soundness, simplicity and transparency (in particular, loan-level reporting is easier to produce and interpret). All underlying exposures must belong to only one of the following types:

Residential loans:

Securitisation positions may be backed by loans secured by a first-ranking mortgage and/or by fully-guaranteed residential loans as referred to in Article 129(1)(e) of the Capital Requirements Regulation. In both cases, the pool of loans must feature on average a loan-to-value ratio lower than or equal to 80%. In the case of mortgage loans only, it is possible to derogate from this loan-to-value requirement, provided that instead, the national law of the Member State where the loans are originated provides for a maximum loan-to-income ratio not higher than 45%, and each loan in the pool complies with this limit. The relevant national law must be communicated to the Commission, and EBA and/or EIOPA.

Loans, leases and credit facilities to undertakings, in particular SMEs:

Securitisation positions may be backed by commercial loans, leases and credit facilities to undertakings to finance capital expenditures or business operations other than the acquisition or development of commercial real estate, provided that at least 80% of the borrowers in the pool in terms of amount are small and medium-sized enterprises at the time of issuance of the securitisation.

Auto loans or leases:

Securitisation positions may be backed by loans or leases for the financing of a broad range of vehicles. Such loans or leases may include ancillary insurance and service products or additional vehicle parts, and in the case of leases, the residual value of leased vehicles[12]. All loans and leases in the pool shall be secured with a first-ranking charge or security over the vehicle or an appropriate guarantee in favour of the securitisation special purpose vehicle.

Consumer loans and credit card receivables:

Securitisation positions may be backed by loans and credit facilities to individuals for personal, family or household consumption purposes.

As a consequence of this closed list of eligible underlying exposures, commercial mortgage backed securities (CMBS) and collateralised debt obligations (CDOs)[13] are excluded. This is justified given their poorer performance, as shown in EIOPA's advice and other studies of CMBS.[14]

No re-securitisations, no synthetic securitisations

Re-securitisations are explicitly excluded, as they are typically complex and less transparent structures, where the cascading of investor losses is very difficult to understand due to re-tranching.

The same goes for synthetic securitisations, where the underlying exposures are not transferred to the special purpose vehicle. Instead, the transfer of risk is achieved by the use of credit derivatives or guarantees, while the exposures being securitised remain with the originator. The transfer of the assets to be securitised ensures that securitisation investors have recourse to those assets should the Securitisation Special Purpose Entity (SSPE) not fulfil its payment obligations. Such recourse cannot be granted in synthetic transactions, due to the fact that only the credit risk associated with the underlying assets, rather than the ownership of such assets, is transferred to the SSPE. Such a structure also adds counterparty risk on derivatives or guarantees, and hampers investors' rights to the proceeds of the underlying exposures. In addition, most synthetic structures add to the complexity of the securitisation in terms of risk modelling.

15.1.3. Restricted use of derivatives and transferable financial instruments

Derivatives can only be used for hedging currency and interest rate risk. This also excludes the synthetic securitisations described in the above paragraph.

The pool of underlying exposures must not include transferable financial instruments (this effectively means CDOs are excluded), except financial instruments issued by the securitisation special purpose entity itself, in order to accommodate master trust structures.

15.1.4. 'True sale' and absence of severe 'claw back' provisions

The transfer of the underlying exposures to the securitisation special purpose vehicle must be sufficiently certain from a legal point of view:

- the transfer must be enforceable against any third party and the underlying exposures be beyond the reach of the seller (originator, sponsor or original lender) and its creditors, including in the event of the seller's insolvency ('true sale' requirement);
- the transfer of the underlying exposures to the SSPE may not be subject to any severe clawback provisions in the jurisdiction where the seller is incorporated because such provisions induce legal insecurity on investors' rights.

15.1.5. Continuity provisions for the replacement of servicers, derivative counterparties and liquidity providers

The underlying exposures must have their administration governed by a servicing agreement which includes servicing continuity provisions to ensure, at a minimum, that a default or insolvency of the servicer does not result in a termination of servicing.

Where applicable, the documentation governing the securitisation must also include continuity provisions to ensure, at a minimum, the replacement of derivative counterparties and liquidity providers upon their default or insolvency.

The aim of these two criteria is to mitigate credit risk with different counterparties involved in the securitisation transaction, whose default or insolvency could jeopardise the smooth running of the transaction.

15.1.6. Absence of credit-impaired obligors

At the time of issuance of the securitisation or when incorporated in the pool of underlying exposures at any time after issuance, the underlying exposures must not include exposures to credit-impaired obligors (or where applicable, credit-impaired guarantors). The definition of credit-impaired obligors or guarantors is both backward-looking (e.g. the obligor has declared bankruptcy, or has recently agreed with his creditors to a debt dismissal or reschedule, or is on an official registry of persons with adverse credit history) and forward-looking (e.g. the obligor has a credit assessment by an external credit assessment institution or has a credit score indicating a significant risk that contractually agreed payments will not be made compared to the average obligor for this type of loans in the relevant jurisdiction).

This criterion effectively excludes 'sub-prime' loans from the high-quality securitisation category.

15.1.7. Absence of loans in default

At the time of issuance of the securitisation or when incorporated in the pool of underlying exposures at any time after issuance, the underlying exposures must not include exposures in default, as defined in the banking prudential rules in Article 175 of Regulation (EU) No 575/2013. This criterion ensures that the securitisation does not contain loans or leases already in default when the securitisation transaction begins or when new exposures are transferred to the SSPE.

15.1.8. Reliance on the future sale of assets securing the exposures

The repayment of the securitisation position must not be structured to depend predominantly on the sale of assets securing the underlying exposures; however, this shall not prevent such exposures from being subsequently rolled over or refinanced.

The point of this criterion is to exclude transactions where the ability of the SSPE to repay the securitisation notes is subject to an unacceptable level of risk, due to overreliance on the proceeds of the sale of assets securing the underlying exposures such as used cars when an auto lease securitisation transaction matures. While recognising that auto lease securitisations including residual values may be eligible as high quality (see paragraph 15.1.2), the repayment of those securitisations should not rely predominantly on the future realisation of those residual values.

15.1.9. Pass-through requirement for non-revolving structures

Cash proceeds from the underlying exposures should flow in a simple and transparent way to investors. Structures where a significant amount of cash is retained within the SSPE (for example, securitisations with bullet payments) would not comply with this pass-through profile and, therefore, are excluded.

15.1.10. Early amortisation provisions for revolving structures

Where the securitisation has been set up with a revolving period, the transaction documentation provides for appropriate early amortisation events, which shall include at a minimum all of the following:

- a deterioration in the credit quality of the underlying exposures;
- a failure to generate sufficient new underlying exposures of at least similar credit quality;
- the occurrence of an insolvency-related event with regard to the originator or the servicer.

High-quality securitisations should ensure that, in the presence of a revolving period mechanism, investors are sufficiently protected from the risk that principal amounts may not be fully repaid. Sufficient protection should be ensured by the inclusion of provisions which trigger amortisation of all payments at the occurrence of adverse events such as those mentioned in the criterion.

15.1.11. At least one payment at the time of issuance

At the time of issuance of the securitisation, the borrowers (or, where applicable, the guarantors) must have made at least one payment. This is intended to exclude securitisation backed by newly-originated loans. However, this requirement would not be proportionate in practice for the securitisation of credit card receivables. Hence there is a derogation for this type of securitisation.

15.1.12. Absence of self-certified loans

In the case of securitisations backed by residential loans, the pool of loans must not include any loan that was marketed and underwritten on the premise that the loan applicant or, where applicable, intermediaries, were made aware that the information provided might not be verified by the lender.

This requirement is essential to exclude loans where the applicant and, where applicable, intermediaries, might be incentivised to misrepresent essential information, e.g. to overstate their income. This criterion also helps exclude 'sub-prime' lending.

15.1.13. Assessment of retail borrowers' creditworthiness

In the case of securitisations where the underlying exposures are residential loans, auto loans or leases, consumer loans or credit facilities, the creditworthiness of the borrowers must be assessed thoroughly, in accordance with the Mortgage Credit Directive (Directive 2014/17/EU) or the Consumer Credit Directive (Directive 2008/48/EC) or equivalent rules in third countries, where applicable. This requirement effectively excludes flawed securitisation business models, relying on unsound underwriting practices.

15.1.14. Transparency and disclosure of loan-level data

Where either the originator or sponsor of a securitisation is established in the Union, they must comply with transparency requirements set out in the Capital Requirement Regulation. Furthermore, in accordance with Article 8b of Regulation (EU) No 1060/2009, the European Securities and Markets Authority (ESMA) will in 2017 set up a website centralising the publication of information regarding structured finance instruments, i.e. securitisations. Through this website, the issuer, originator or sponsor of the securitisation will be able to publish information on the credit quality and performance of the underlying assets of the structured finance instrument, the structure of the securitisation transaction, the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary for investors to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.

Where neither the issuer, nor the originator, nor the sponsor of a securitisation is established in the Union, comprehensive loan-level data in compliance with standards generally accepted by market participants must be made available to existing and potential investors and regulators at issuance and on a regular basis.

15.1.15. Listing requirement

Both the Solvency II and LCR delegated acts require that high-quality securitisation positions should be listed on a regulated market/recognised exchange, or admitted to trading on another organised venue, with a robust market infrastructure. The drafting of this criterion could not be strictly aligned in the two acts because of legal constraints stemming from differences in the corresponding 'level 1' legislation[15]. In addition, under the LCR delegated act, securitisation positions may be deemed highly liquid if they are tradable on generally accepted repurchase markets. This was not included in the Solvency II delegated act as repurchase transactions to generate liquidity are not typical for insurers.

15.1.16. Credit quality

Both the Solvency II and LCR delegated acts require that high-quality securitisation positions receive a minimum external credit assessment, on issuance and at any time thereafter.

The minimum external credit assessment is one of the elements for high-quality securitisation positions and does not constitute sole and mechanistic reliance, in accordance with the principles of the Financial Stability Board for reducing reliance on CRA ratings[16].

In Solvency II, the position should be investment grade, i.e. be assigned to credit quality step 3 at least.

In order to ensure that the securitisation position is highly liquid, the LCR delegated act requires that it is assigned to credit quality step 1.

The mappings of external credit assessments onto the respective scales of credit quality steps applicable in banking and insurance legislation is prepared by the Joint Committee of the European Supervisory Authorities.

[1] The Solvency Capital Requirement is a level of financial resources that enables insurers to absorb significant losses and that gives reasonable assurance to policy holders and beneficiaries that payments will be made as they fall due. The Minimum Capital Requirement is a lower, minimum level of security below which the amount of insurers' financial resources should not fall, otherwise supervisory authorities may withdraw authorisation.

[2] See Article 132 of the Solvency II Directive. Insurers shall only invest in assets whose risks they can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of their overall solvency needs.

[3] Listed in Annex 2 of the impact assessment for the Solvency II delegated act.

[4] A perfect match could neutralise completely the capital requirement for interest rate risk, which is one of the main components of the total capital requirement for life insurers in particular.

[5] See Impact Assessment report for the adoption of the Solvency II Directive, page 50.

[6] For the sample of the EU life insurance sector participating in the "long-term guarantees" technical assessment, the capital surplus under Solvency I was EUR 110 bn on 31.12.2011 (at the peak of the

sovereign crisis). The results under the package of measures introduced by Omnibus II (volatility adjustment, matching adjustment, extrapolation of the risk-free rate, and transitional measures on the risk-free rate and technical provisions) should be close, possibly even higher (no date available on the impact of the final amendments in the negotiations, which should increase the benefits of the package).

[7] Insurers have to set up provisions for the future payments to policyholders in relation to their insurance obligations (so-called technical provisions). Technical provisions are discounted to allow for the time value of money. Discounting has a significant impact on the size of technical provisions, the higher the discount rate the lower the technical provisions. Under Solvency II technical provisions are discounted with risk-free interest rates.

[8] The trading book includes all positions in financial instruments and commodities held by a bank with trading intent, or in order to hedge positions held with trading intent.

[9]This analysis examined the liquidity of some asset backed securities against a number of metrics. However, this work was not sufficient for EBA to recommend the inclusion of ABS (apart from RMBS) as HQLA for the purposes of LCR.

[10] By virtue of Article 135(2) of Directive 2009/138/EC (Solvency II).

[11] By virtue of Article 405 of Regulation (EU) No 575/2013 (CRR).

[12] Auto loans or lease securitisations including residual values must however comply with paragraph 0 below, which prevents the repayment of the securitisation depending predominantly on the sale of the vehicles.

[13] CDOs are also excluded by virtue of the criteria in point 0 because their underlying exposures usually include transferable debt instruments, such as non-investment grade bonds.

[14] See page 121 of EIOPA's technical report (2013).

[15] On the one hand, the Solvency II Directive uses the concept of a "regulated market" as defined in Article 13(22). On the other hand, the Capital Requirements Regulation uses the concept of a "recognised exchange" as defined in Article 4(1)(72). While the latter is also based on the concept of a "regulated market", the CRR definition also includes clearing mechanism requirements.

[16] Available at: http://www.financialstabilityboard.org/publications/r_101027.pdf

MEMO/15/3120