GUIDELINES

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on the treatment of market and counterparty risk exposures in the standard formula

EIOPA-BoS-25/664
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European Insurance and
Occupational Pensions Authority

GUIDELINES ON THE TREATMENT OF MARKET AND COUNTERPARTY RISK EXPOSURES IN THE STANDARD FORMULA

INTRODUCTION

1. In accordance with Article 16 of Regulation (EU) No 1094/2010 (EIOPA Regulation)[1], EIOPA issues revised Guidelines on the treatment of market and counterparty risk exposures in the standard formula.
2. The Guidelines relate to Articles 104 and 105 of Directive 2009/138/EU (Solvency II)[2] as well as to Articles 164 to 202 of Commission Delegated Regulation (EU) 2015/35 [3].
3. These Guidelines are addressed to the supervisory authorities under Solvency II.
4. These Guidelines aim at facilitating convergence of practices across Member States and supporting undertakings in applying the market and counterparty default risk modules of the standard formula.
5. For the purpose of these Guidelines, the following definition has been developed:
    - 'short equity position' means a short position relating to equity resulting from a short sale within the meaning of paragraph 1(b) of Article 2 of Regulation (EU) No 236/2012 [4].
6. If not defined in these Guidelines, the terms have the meaning defined in the legal acts referred to in the introduction.
7. The Guidelines repeal and replace the Guidelines on the treatment of market and counterparty risk exposures in the standard formula (EIOPA-BoS-14-174).

GUIDELINE 1 – IMPACT OF OPTIONS ON THE DURATION OF BONDS AND LOANS

8. When determining the duration of bonds and loans, insurance and reinsurance undertakings (collectively "undertakings") should take into account options granted to the issuers of the bonds and loans which might decrease or increase their maturity. The determination of the duration of such bonds and loans should be based on prudent assumptions that reflect stressed conditions.

GUIDELINE 2 – INTEREST RATE RISK SUB-MODULE

9. Undertakings should include all interest rate sensitive assets and liabilities in the calculation of the capital requirement for the interest rate risk sub-module.
10. The technical provision should be recalculated under the scenarios using the risk free interest rate term structure after the shock, which is determined by stressing the basic risk free interest rate

[1] Regulation (EU) No 1094/2010,of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (EIOPA Regulation) (OJ L 331, 15.12.2010, p. 48–83).

[2] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1-155).

[3] Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC (OJ L 12, 17.01.2015, p. 1-797).

[4] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (OJ L 86, 24.03.2012, p. 1-24).

term structure and adding back matching adjustment, volatility adjustment or transitional measure on the risk free rate under Article 308 (c) of the Solvency II Directive, if applicable.

11. The assets value should be recalculated under the scenarios by stressing only the basic risk free interest rate term structure and any spreads over the basic risk free interest rate term structure should remain unchanged. This may involve using a mark to model valuation for determining the value of the assets under the stresses.
12. Insurance and reinsurance undertakings should ensure that the values of assets before the stresses obtained by using a mark-to-model valuation are consistent with the quoted market prices of relevant assets in active markets.

GUIDELINE 3 – INVESTMENTS WITH EQUITY AND DEBT INSTRUMENT CHARACTERISTICS

13. Where assets exhibit debt and equity instrument characteristics, undertakings should take into account both of these characteristics when determining which standard formula risk modules and sub-modules should apply.
14. When determining which standard formula risk modules and sub-modules apply, undertakings should consider the economic substance of the asset.
15. Where the asset can be considered as the composite of discrete components, undertakings should where appropriate apply the relevant stresses to each of these components separately.
16. Where it is not possible to consider the asset as the composite of discrete components, undertakings should base the determination of which of the standard formula risk modules and sub-modules apply on whether the debt or equity characteristics predominate in an economic sense.

GUIDELINE 4 – FINANCIAL RISK-MITIGATING INSTRUMENTS AND SHORT EQUITY POSITIONS

17. Any risk mitigating effect of financial risk-mitigating instruments, including short equity positions, can only be considered if they comply with Articles 208 to 215 of Commission Delegated Regulation 2015/35. Otherwise, they should only be considered under those stressed scenarios where they contribute to a decrease in value of own funds.

GUIDELINE 5 – COMMITMENTS WHICH MAY CREATE PAYMENT OBLIGATIONS

18. For legally binding commitments where no nominal value is explicitly mentioned in the commitment arrangement, undertakings should determine the corresponding loss-given-default, as referred to in Article 192(5) of Commission Delegated Regulation 2015/35, on the basis of an estimated nominal value.
19. The estimated nominal value is the maximum amount that is expected to be paid in case of a credit event of the counterparty.

GUIDELINE 6 – TREATMENT OF LEVERAGED FUNDS

20. Where undertakings calculate the market risk module and apply the look-through approach for a leveraged investment fund, they should consider the leverage of the fund under the relevant market risk sub-modules. The change in value of the investment fund should be the net change

after applying the market risk sub-module stress to the gross assets and reducing the resulting value by the value of the outstanding borrowing.

21. For a highly leveraged investment fund, the outcome of the calculation of the relevant sub-modules might be a reduction of the value of the investment fund exceeding 100 percent. In this case, the reduction of the value should be assumed to be 100 percent.

COMPLIANCE AND REPORTING RULES

22. This document contains guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16(3) of the EIOPA Regulation, competent authorities and financial institutions are required to make every effort to comply with guidelines and recommendations.
23. Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.
24. Competent authorities are to confirm to EIOPA whether they comply or intend to comply with these Guidelines, with reasons for non-compliance, within two months after the issuance of the translated versions.
25. In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.

FINAL PROVISION ON REVIEW

26. These Guidelines will be subject to a review by EIOPA.

Annex – Examples for the treatment of leveraged funds

EXAMPLE 1

Suppose an insurance company (hereinafter “IC”) which invests 40 million euros of equity in a leveraged investment vehicle (hereinafter "LF"). In doing so, IC holds 20% of the equity of LF. LF invests exclusively in private equity, up to 350 million euros.

The application of the 49% shock on private equity leads to a 49% decrease in the value of the private equity investments as there are no risk mitigating instruments in place.

The SCR calculation for the equity risk along with the total balance sheet approach is illustrated below.

Before the type 2 equity shock

Insurance company or IC			
Assets		Liabilities	
Equity in LF	40	Own Funds	100
Other Assets	960	Liabilities	900
Total	1000	Total	1000

IC holds 20% of equity of LF = 20%*200 = 40

Leveraged fund or LF			
Assets		Liabilities	
Private Equity	350	Equity	200
		Debt	150
Total	350	Total	350

The application of the private equity shock gives rise to a capital requirement of 34.3 million (350*49%*20%) euros for the IC.

In relative terms, this results in a risk weighting of 34.3/40 = 85.75%, i.e., 1.75 times the relative weighting applicable to the risk on private equity (1.75*49% = 85.75%).

This factor of 1.75 is the result obtained by dividing the value of the private equity investments of the LF by the value of the equity of the LF (350/200 = 1.75). It represents the leverage ratio calculated as the total assets to equity of the LF.

After the type 2 equity shock

Insurance company			
Assets		Liabilities	
Equity in LF (= 40-34.3)	5.7	Own Funds (= 965.7-900)	65.7
Other Assets	960	Liabilities	900
Total	965.7	Total	965.7

IC holds 20% of equity of LF = 20%*28.5 = 5,7

LF (leveraged fund)			
Assets		Liabilities	
Private Equity (= 350*(1-49%))	178.5	Equity (= 178.5-150)	28.5
		Debt	150
Total	178.5	Total	178.5

In comparison to the correct SCR calculation above, an approach where solely the net asset value (NAV) of the LF is stressed, would result in a capital requirement of 19.6 million (200*49%*20%).

By neglecting the leverage in the fund, the equity risk would substantially be underestimated.

EXAMPLE 2

Suppose an insurance company (hereinafter “IC”) which invests 30 million euros of equity in a leveraged investment vehicle (hereinafter "LF"). In doing so, IC holds 20% of the equity of LF. LF invests exclusively in private equity, up to 350 million euros.

The LF is now mainly debt-financed with debt of 200 and equity of 150. Other assets have now the value of 970 in the insurance company’s balance sheet.

Before the type 2 equity shock

Insurance company or IC			
Assets		Liabilities	
Equity in LF	30	Own Funds	100
Other Assets	970	Liabilities	900
Total	1000	Total	1000

IC holds 20% of equity of LF = 20%*150 = 30

Leveraged fund or LF			
Assets		Liabilities	
Private Equity	350	Equity	150
		Debt	200
Total	350	Total	350

An immediate application of the private equity shock results in a capital requirement of 34.3 million (350*49%*20%) euros for the IC, which exceeds the amount of its investment in LF.

Accordingly, the capital requirement needs to be capped by the IC's investment in the LF.

Therefore, the capital requirement is 30 (min(34.3,30)=30). This implies that for this highly leveraged investment fund the entire equity in the LF is lost under the type 2 equity scenario and the relative risk weight is 100%.

<u>After the type 2 equity shock</u>

Insurance company			
Assets		Liabilities	
Equity in LF (=30-min (34.3,30))	0	Own Funds (=970-900)	70
Other Assets	970	Liabilities	900
Total	970	Total	970

IC holds 20% of equity of LF = 20%*max (0,-21.5) = 0

LF (leveraged fund)			
Assets		Liabilities	
Private Equity (= 350*(1-49%))	178.5	Equity (=178.5-200)	-21.5
		Debt	200
Total	178.5	Total	178.5