EIOPA-CP-17/003
26 April 2017

# Call for Evidence

# Request by the European Commission to EIOPA for Technical Advice on the treatment of unlisted equity and debt without an ECAI rating in the standard formula

## Responding to this paper

EIOPA welcomes responses to the Call for evidence concerning the request by the European Commission to EIOPA for technical advice on the treatment of unlisted equity and debt without an External Credit Assessment Institution (ECAI) rating in the standard formula.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale;
- support statements with evidence where appropriate; and
- describe any alternatives EIOPA should consider.

<u>Please send your comments to EIOPA in the provided Template for Comments, by email **CP-17-003@eiopa.europa.eu** until 24 May 2017 23:59 CET.</u>

<u>Contributions not provided in the template for comments, or sent to a different email address, or after the deadline will not be processed.</u>

### Publication of responses

Contributions received will be published on EIOPA's public website unless you request otherwise in the respective field in the template for comments. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.

Please note that EIOPA is subject to Regulation (EC) No 1049/2001 regarding public access to documents and EIOPA's rules on public access to documents[1].

Contributions will be made available at the end of the public consultation period.

### Data protection

Please note that personal contact details (such as name of individuals, email addresses and phone numbers) will not be published. They will only be used to request clarifications if necessary on the information supplied.

EIOPA, as a European Authority, will process any personal data in line with Regulation (EC) No 45/2001 on the protection of the individuals with regards to the processing of personal data by the Community institutions and bodies and on the free movement of such data. More information on data protection can be found at https://eiopa.europa.eu/ under the heading 'Legal notice'.

[1] Public Access to Documents

# Background

Recital 150 of Commission Delegated Regulation (EU) 2015/35 on Solvency II ("Delegated Regulation") states the intention of the European Commission ("COM") to review certain elements of the standard formula until the end of 2018.

Before this background COM issued a first call for advice to EIOPA in July 2016 which focused on the areas "proportionate and simplified application of the requirements" and "removal of unintended technical inconsistencies".

On 21 February 2017 EIOPA received a second call for advice on the Delegated Regulation,[2] which covers the "removal of unjustified constraints to financing". It requests advice in the areas of debt where no credit assessment by a nominated ECAI is available (in the following simply "unrated debt"), unlisted equities and strategic equity investments. Given the nature of the request this call for evidence does not cover the latter topic.

As a first step in reducing over-reliance on external credit ratings for regulatory purposes, EIOPA is asked to provide clear and conclusive criteria for unrated debt, in order to identify those instruments with a better risk profile.

Such criteria can be related to the financial state of the debtor, the features of the instrument concerned, the transparency offered to investors. In addition such criteria can also be related to the insurer's own risk management system

EIOPA is also asked to provide clear and conclusive criteria applicable to portfolios of unlisted equity from the European Economic Area (EEA) (in the following simply "unlisted equities") that allow to identify those instruments which could benefit from the same risk factor as listed equity.

Such criteria can be related to the characteristics of the portfolio, in particular the diversification achieved and the transparency offered to the investor on the company. The consideration taken for environmental, social and governance aspects could also be taken into account.

Such criteria can also be related to the asset management skills and strategy and to the insurer's own risk management system.

## Purpose of the paper

In order to allow stakeholders to provide their views and ideas in an early stage and to collect relevant evidence EIOPA decided to issue this call for evidence. For this purpose this paper contains a number of questions to stakeholders.

[2] https://ec.europa.eu/info/files/request-eiopa-technical-advice-review-specific-items-solvency-ii-delegated-regulation-eu-2015-35_en

## Next Steps

Based on the feedback received and further work, EIOPA will prepare draft advice to the European Commission. It is planned to start a consultation on these proposals in November 2017.

# 1. Questions on unrated debt

*Your answers on the questions below would be most helpful if they specified as much as possible how the proposed criteria can be made operational (e.g. in the case of transparency, how one would measure the degree of transparency), how they affect the risk and what the evidence is.*

**Suggestion for methods and criteria**

1. Do you have any suggestions for methods and criteria (in the following "approaches") to identify unrated debt that could receive the risk charge for rated debt with credit quality step (CQS) 1, 2 or 3?
2. Which criteria do you suggest based on the
    a. financial state of the debtor (in particular financial ratios based on financial statements)?
    b. features of the instrument concerned, in particular covenants and to its position in the credit hierarchy in case of default?
    c. transparency offered to investors as regards the debtor?
    d. insurer's own risk management system, to ensure its ability to manage properly risks related to investments in bonds and loans for which no credit assessment by a nominated ECAI is available? How would this result in reinforced risk management compared to rated debt?
    e. any other factors?

**Properties and evidence regarding the proposed approaches**

3. What is the evidence on the ability of your proposals to reliably identify unrated debt with a risk profile that justifies applying the risk factors for rated debt with CQS 1 to 3? On what basis do you decide whether the same treatment as for a rated debt instrument with a certain credit quality step is adequate?
4. How easily available are the data needed to apply your criteria?
5. Have you ever compared your approaches with the methodologies used by rating agencies? If so, what are the differences?

**Information on unrated debt**

6. Can you provide data on
    a. the characteristics of unrated debt (in particular private placements) issued in Europe (e.g. properties of the issuing companies, seniority, collateralisation, maturity, volumes)?
    b. its risk profile (e.g. default and recovery rates, default and recovery correlations)?
    c. the proportion of unrated debt with credit risk corresponding to CQS 0 to 6 (e.g. based on the results of internal models)?

7. What are the specific types of unrated debt insurers invest in? How well diversified are their unrated debt portfolios? Can you provide any of the information referred to in question 6 for this specific debt?
8. How do insurers invest in unrated debt (direct investment, specialised funds, in cooperation with banks etc.)?
9. Are there any sources for data, criteria or methods or any studies on the topic that EIOPA should consider?

**Effects of a possible change**

10. For the approaches you suggested above:
    a. What are the volumes of the exposures that would qualify as CQS 1 to 3 (both in absolute terms and as a share of (a segment of) the unrated debt market)?
    b. What share would they represent in the portfolios of internal model and standard formula insurers respectively (relative to all investments and the unrated debt)?

**Further technical information**

11. What are the characteristics of European companies (in general and for different sectors) in different rating categories (AA, A etc.) with respect to financial ratios like interest coverage, leverage, return on assets etc.?
12. How relevant is
    a. qualitative information on the borrower (e.g. performance, experience, market share, quality of management, operating environment including applicable regulation, quality of financial reporting and disclosures, qualifications by auditors, post balance sheet events)
    b. comparative information on the borrower (e.g. credit ratings of peer companies when available, distinction between the borrower and its peers)

    for the assessment of the risk? Why?
13. One might consider allowing a standard formula insurer to use the credit assessment for a debt instrument produced by the internal model of a bank/another insurer that was approved for the calculation of its regulatory capital requirement.
    a. What would be possible problems?
    b. How could it be ensured that the standard formula insurer using the results of such a model has a sufficient understanding?
    c. Would mechanisms be needed to ensure that the internal model bank/insurer has sufficient “skin in the game”?

## 2. Questions on unlisted equities

*The same recommendations as set out at the beginning of the section on unrated debt are relevant for this section.*

**Suggestion for methods and criteria**

1. Do you have any suggestions for criteria and methods ("approaches") to identify portfolios/types of unlisted equities to which the type 1 equity risk charge could be applied?
2. Which criteria do you suggest based on the
    a. characteristics of the portfolio, in particular the diversification achieved either directly or through funds?
    b. the transparency (type and (minimum) frequency of information) offered to the investor on the company in question, either by the fund manager or by the company itself?
    c. the consideration taken for environmental, social and governance aspects?
    d. the asset management skills and strategy and the insurer's own risk management system, to ensure its ability to pursue investments in unlisted equity and to manage properly risks related to them, either directly or through funds?
    e. any other factor?

**Properties of the proposed approaches and evidence**

3. What is the (quantitative) evidence on the ability of your proposed approaches to identify unlisted equities which merit the type 1 equity risk charge? How do you measure that the risk is comparable?
4. How easily available are the data to apply the criteria?

**Information on unlisted equities**

5. Can you provide data on the characteristics of unlisted equity investments in companies in the EEA in general (e.g. properties of the issuing companies like sector, size and leverage, volumes, diversification) and on its risk profile (e.g. volatility of cash flows and profits)?
6. How similar are unlisted companies to listed companies included in the major equity indices in terms of
    a. risk-relevant properties (e.g. sectors, leverage, diversification across business lines and geographies)?
    b. volatility of revenues, cash flows and profits?
7. Are there any sources for data, criteria or methods or any (academic) studies on the topic that EIOPA should consider?

**Investment by insurers in unlisted equity**

8. What are the characteristics of unlisted equity investments in companies in the EEA by internal model and standard formula insurers respectively? Can you provide any of the information referred to in question 6?
9. How do insurers invest in unlisted equities (direct investment, specialised funds etc.)?
10. Can you provide information on the due-diligence and risk management processes that insurers investing in unlisted equities implement and their strategy? What are the main features of insurers' internal policy on investment in unlisted equity?
11. How do insurers diversify their investments in unlisted equity investments?
12. What information is provided to insurers investing in unlisted equities at the outset of the transaction and afterwards at what frequency? How does this compare to the disclosure available on listed companies?
13. How much consideration is taken for environmental, social or governance aspects in unlisted equity investments in general and for the investments by insurers in specific? How are environmental, social or governance aspects made operational (label, scores etc.)?
14. What information can you provide on the asset management skills of the insurer or private equity fund(s)?

**Further technical information**

15. In addition to requirements on transparency, listing requirements may include conditions on earnings record, governance etc.
    To what extent do the unlisted companies that meet your criteria meet the listing requirements for the major exchanges and what impact does this have on their risk?
16. Should corporates that solely invest in unlisted equities also be included? What method should be used for these types of corporates?

**Effects**

17. For the methods and criteria you suggested above: What are the volumes of unlisted equities that would qualify (both in absolute terms and as a share of (a segment of) the unlisted equity market)?
18. What share in the portfolios of internal model and standard formula insurers respectively do they currently represent (relative to all investments and unlisted equities)? How might this change in the future?