

Q&A

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

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Question

I am seeking clarification on the appropriate treatment of reverse repurchase agreements under the Solvency II Standard Formula SCR. I don't believe that such transactions are explicitly covered within either the Level 1 Directive or the Level 2 Delegated acts, but instead are only referred to within the Level 3 Guidelines.

Guideline 8 paragraph 1.24 of the document "Guidelines on the treatment of market and counterparty risk exposures in the standard formula" is of relevance as it states:

"1.24. When determining the capital requirements for securities lending or borrowing transactions and repurchase or reverse repurchase agreements including liquidity swaps, undertakings should follow the recognition of the exchanged items in the Solvency II balance sheet. They should also take into account contractual terms and risks stemming from the transaction or agreement."

The example that follows in paragraph 1.27 makes it very clear that, for a regular repurchase agreement in which the undertaking borrows cash and lends a bond, with both assets recognized on the balance sheet, the capital position derives from the combination of the bond's spread risk and the counterparty risk associated with return of that bond mitigated by the liability to repay the borrowed cash. The borrowed asset, being cash, has no risk.

"1.27. If the lent asset and the received asset are recognised in the Solvency II balance sheet, undertakings should:

(a) apply the relevant market risk sub-modules to the lent asset and the

borrowed asset;

(b) include the lent asset in the calculation of the capital requirement for counterparty default risk on type 1 exposures, taking into account the risk-mitigation that the received asset provides if it is recognised as collateral in accordance with the requirements set out in Article 214 of Commission Delegated Regulation 2015/35;

(c) consider liabilities on its balance sheet which result from the lending arrangement in the calculation of the capital requirement for the interest rate risk sub-module.”

I believe that reverse repos in which the lent asset is cash, which becomes de-recognized on the balance sheet, and the received asset is a bond, also not recognized on the balance sheet, should be treated in analogous fashion. Unfortunately there is no example for the case where neither received nor lent asset is recognized on the balance sheet. Instead the asset appearing is a “financial receivable” corresponding to the repayment of the cash which the undertaking has lent. I imagine the guidance for that case, if it existed, ought to look something like:

“1.xx. If neither the lent asset nor the received asset are recognised in the Solvency II balance sheet, undertakings should:

(a) include the lent asset in the calculation of the capital requirement for counterparty default risk on type 1 exposures, taking into account the risk-mitigation that the received asset provides if it is recognised as collateral in accordance with the requirements set out in Article 214 of Commission Delegated Regulation 2015/35;

(b) consider assets on its balance sheet which result from the lending arrangement in the calculation of the capital requirement for the interest rate risk sub-module.”

In other words, I interpret Guideline 8, in the case of reverse repurchase agreements, as requiring us to hold capital for the difference between the value of the financial receivable and the risk-mitigation provided by the received assets (subject to meeting the requirements of Article 214), as part of our counterparty default type 1 calculations. I would also expect to hold capital against any interest rate sensitivity of the financial receivable.

This treatment is the same as that shown in example 1.25 with the understanding that the lent asset is cash, which has no market risk anyway, but is automatically de-recognized from the balance sheet.

“1.25. If the lent asset remains on the balance sheet and the received asset is not recognised, undertakings should:

(a) apply the relevant market risk sub-modules to the lent asset;

(b) include the lent asset in the calculation of the capital requirement for counterparty default risk on type 1 exposures, taking into account the risk-mitigation that the received asset provides if it is recognised as collateral in accordance with the requirements set out in Article 214 of Commission Delegated Regulation 2015/35.”

EIOPA answer

The described transaction is economically equivalent to a collateralised loan.

The “financial receivable” corresponding to the repayment of the cash which the undertaking has lent should be included in the calculation of the capital requirements for interest rate and spread risk. In case the requirements set out in Article 176 Par. 5 should be met, the risk-mitigating effect of the bond collected can be recognized as described therein.

There is no need to include the lent cash in the calculation of the capital requirement for counterparty default risk on type 1 exposures.