
# SOLVENCY II (EU AND UK): ENCOURAGING INSURERS BACK TO THE SECURITISATION MARKETS?

This is an update of an article originally published on 5 June 2023 as part of our publication "Securitisation markets and regulation: choosing different paths?", accessible here.

Following the 2008 financial crisis, European (re)insurance companies cut back on their securitisation investments. This effect was aggravated by the introduction of Solvency II in 2016 which, in effect, penalised insurers' investments in securitisation. European insurers have yet to fully re-enter the securitisation markets. In this article, we consider the outlook for (re)insurers' participation in ABS markets in the coming years in light of proposed reforms to EU and UK regulatory regimes and the expected impact on (re)insurers' investment behaviour.

**Key Issues**

- Low participation of EU and UK (re)insurers in securitisations may be connected to punitive capital charges and UK matching adjustment rules under Solvency II.
- Revised capital requirements under STS do not appear to have revived EU and UK (re)insurers' interest in securitisations.
- UK proposal to amend matching adjustment rules to allow assets with highly predictable cashflows may increase UK (re)insurers' investments in securitisations.
- It is hoped that UK and EU will also review capital requirements with a view to making securitisations more attractive to (re)insurers.

## SETTING THE CONTEXT

Securitisation was widely viewed by policymakers as a key driver of the 2008 global financial crisis and a significant contributor to the long chains of financial intermediation that worsened it. The uncertainty and loss of confidence in the ABS markets following the crisis led to a decline in securitisation issuances and investments across global markets. Although the European ABS market performed relatively well during the financial crisis as compared to its US counterpart (as measured by defaults and downgrades), the European ABS market nevertheless suffered a contraction from which it has yet to recover. According to data compiled by the Association for Financial Markets in Europe ("**AFME**"), annual placed issuance levels dropped from €450bn in the pre-crisis years (in 2006 – 2007) to €108bn as at the end of 2019[1], and fell further to €79bn by the end of 2022[2].

As a response to the crisis, securitisation investors including banks, pension funds and insurance companies cut back on their securitisation investments. AFME estimates that the total European placed issuance fell to a record low of €24bn in 2009 as most of the securitisation transactions during this period were retained – typically to provide collateral for central bank liquidity schemes. In particular, the EU insurance industry witnessed a massive shrinkage in insurers' ABS portfolios. This contraction was driven by insurers' need to comply with more conservative post-crisis capital requirements, including for securitisation investments, which were introduced by the EU as a

[1] https://www.afme.eu/key-issues/securitisation

[2] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Data%20Snapshot%20Q1%202023.pdf

regulatory response to the crisis. The new capital requirements were introduced by Solvency II which was finalised in 2009 but did not become effective until 2016. The introduction of Solvency II resulted in European (re)insurance companies (which pre-crisis, were key ABS investors) reducing their ABS holdings. With Solvency II now effective (and onshored in the UK following the end of the Brexit implementation period), many European and UK insurers have exited the ABS markets. The European Insurance and Occupational Pensions Authority ("EIOPA") estimates that the volume of insurers' investments in European securitisations had stabilised at 0.34% of total investment assets since the introduction of Solvency II.

## Solvency II

Solvency II (Directive (2009/138/EC) and associated legislation) introduced a new prudential regime for insurance and reinsurance undertakings in the EU. Compared to the old Solvency I framework, Solvency II takes a more risk-based approach to the calculation of capital that allows for an assessment of the overall solvency of (re)insurance undertakings.

The revised capital requirements and matching adjustment rules introduced under Solvency II have had an important impact on (re)insurers' investments in securitisations, which we explore in more detail below.

### Capital Requirements

Solvency II originally divided securitisation positions into three categories for the purpose of calculating capital charges. In descending order of capital intensity, they were type 1, type 2 and re-securitisation positions. Type 1 securitisation referred to the most senior tranche of a securitisation of certain common, granular asset classes and meeting relatively high credit quality criteria. Re-securitisations were securitisations whose underlying assets include securitisation positions. Type 2 securitisations were securitisations that were neither type 1 nor re-securitisations.

Under the 2016 Solvency II legislation, the risk factor used for the calculation of the capital charge for a senior RMBS with a credit quality step ("**CQS**")[3] of 1 and a 5-year modified duration was 15% whereas a CMBS with the same CQS and modified duration attracted a risk factor of 67% percent. In sharp contrast to this, a risk factor of 4.5%[4] would be applicable to a covered bond with the same CQS and modified duration and 5.5% for a similar corporate bond. Given the significant differences between the capital charges across various categories of securitisations as compared to comparable assets such as covered bonds and corporate bonds, Solvency II was considered to have the net effect of imposing penal capital charges on insurers with asset-backed securities in their portfolios, leading to calls for reform of the capital treatment of investments in securitisations.

These reforms came in the form of the Securitisation Regulation (Regulation (EU) 2017/2402) ("**EUSR**") which introduced simple, transparent and standardised ("**STS**") securitisations in the EU (which then included the UK). The STS categorisation modified the Solvency II capital calibrations relating to securitisations and replaced the "type 1, type 2 and re-securitisation"

3 The interpretation of the credit quality steps based on allocations by different external credit rating agencies is set out here: https://www.legislation.gov.uk/eur/2020/744/annex/data.xht?view=snippet&wrap=true
4 Article 180 of Commission Delegated Regulation (EU) 2015/35: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&rid=1

categorisations under Solvency II with (in descending order of capital intensity) "senior STS, non-Senior STS, non-STS and re-securitisations".

In effect, the capital charges for senior STS and comparable assets with similar risk profiles such as covered bonds and corporate bonds are broadly similar, thereby in theory, incentivising investments in senior STS securitisations, since these will normally have better yields at a given rating level. However, as a practical matter, according to EIOPA, insurers seem to prefer the non-STS category, which represents more than 70% of insurers' investments in securitisations in 2019 and 2020. This is true notwithstanding that the capital charges for non-senior STS securitisations are much lower than the charges for non-STS, suggesting that a possible explanation for (re)insurer securitisation investment behaviour lies outside the current calibration of Solvency II.[5]

In terms of the actual charges, there is still a significant divide between the capital charges for senior-STS and other categories of securitisations. A snapshot of the capital charges for different asset classes (all with an assumed modified duration of 5 years) is provided in the table below.

| (5-Year Duration) | CQS 1 | CQS 3 | CQS 5 |
|---|---|---|---|
| Covered bonds | 4.5% | - | - |
| Bonds/loans | 5.5% | 12.5% | 37.5% |
| STS senior | 6.0% | 14.0% | 47.0% |
| STS non senior | 17.0% | 39.5% | 100.0% |
| Non STS (other) | 67.0% | 98.5% | 100.0% |

The reduction in capital charges for senior-STS securitisations did not appear to significantly boost investments by (re)insurers in those tranches. In fact, EIOPA reports that since the introduction of the STS label in 2019, a small decrease in investments can be observed in the STS segment of the securitisation market.[6]

In our view, the clear preference shown by (re)insurers for non-STS securitisations over STS securitisations should have served as a basis for the ESAs to review the capital charges for this category to ensure they are risk-sensitive and permit, so far as is prudent, further investments in securitisations.

## Matching adjustment

Solvency II also introduced matching adjustment rules as a countercyclicality measure in response to the duration mismatches which were considered to have increased the sensitivity of life insurers to declines in interest rates during the financial crisis. The matching adjustment offers beneficial capital treatment to insurers writing long-term products (e.g. annuities) who are able to demonstrate that their predictable liability cashflows are closely matched by their asset cashflows and they are therefore not materially exposed to the risk of having to realise those assets in unfavourable circumstances. The matching adjustment allows (re)insurers to recognise upfront, as loss-absorbing capital resources, a proportion of the spread that they hope to earn over the lifetime

[5] https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf
[6] https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf

of their investments on the basis that the asset is intended to be held to maturity and the (re)insurer should therefore not be materially exposed to price movements, but to the risk of default only.

However, the ability of (re)insurers to comply with the matching adjustment rules is constrained by a need to satisfy strict 'fixity' requirements under the current regime. These rules require asset cash flows to be fixed in terms of timing, amount and currency, and not subject to change by the issuers or any third parties. This contrasts with the treatment of liability cashflows which merely have to be predictable and may pose a challenge for securitisation transactions given how typical securitisation transactions are structured around varying asset cash flows.

Interestingly, the UK Government reports that insurers and insurers' annuity funds were major investors in its 2018 securitisation of income contingent student loans.[7] It seems this asset class was attractive to insurers on the basis that the fixity requirements were met and the scheduled amortisation tranche was therefore capable of being held as part of insurers' matching adjustment portfolios.

It is clear from the matching adjustment rules above that cash flow matching for unexpected payments would not be possible as these would not meet the fixity requirement. This poses a challenge to insurers' ability to invest in certain asset classes including most securitisations. In the context of securitisations, deals with e.g. uncertain cash flows, callability and prepayment optionality, unscheduled amortisation and non-performance risk (rather than default risk), would ordinarily not qualify for inclusion in the insurers' matching adjustment-portfolios given that these cash flows would not be fixed in terms of timing and amount. In addition, the terms of certain underlying asset contracts could be considered to give the originator control over the cashflows, therefore failing the fixity requirement e.g. asset contracts which include an originator right to change the terms of the contract for matters such as re-pricing.

There is also an element of subjectivity even where a deal is structured to meet the matching adjustment requirements as set out in Solvency II. The risk remains that a product may not be captured by a firm's approved matching adjustment application, therefore requiring a new matching adjustment regulatory approval for the product.

Where the fixity requirement is not met due to uncertainty concerns, the matching adjustment rules nonetheless allow (re)insurers to include the asset in the matching adjustment portfolio where the terms of the debt provide for sufficient compensation to allow investor to replace lost cash flows by re-investing the uncertain amounts in assets of equivalent or better credit quality. This compensation could take the form of e.g. a make-whole payment for a bond whose cash flows do not meet the fixity requirement, which would require an additional layer of structuring in comparison with other assets such as non-callable corporate bonds. If there is no sufficient compensation, the matching adjustment rules provide that callable bonds may only be recognised up to the first date on which a call may be exercised, resulting in a more limited recognition of cash flows, possibly enough to make investments no longer economic.

[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/914118/Second_Sale_of_Pre-2012_Student_Loans__2_.pdf

It is worth remembering that insurance companies are not barred from holding assets which do not meet the matching adjustment criteria. However, from a practical perspective, we understand that many insurers consider the question of whether an ABS asset can be held in their matching adjustment portfolio as an important pre-condition to investing in ABS given the more favourable capital treatment thereby available. The consequences of including non-matching adjustment assets in a matching adjustment portfolio are also potentially onerous. If not fixed within 2 months, the insurer could lose its matching adjustment approval altogether.

Solvency II has been subject to criticisms from relevant stakeholders in relation to its contribution to the stalled revival of the European securitisation markets. In addition, market commentators have criticised the Solvency II capital charges for being too high and not reflective of default performance during the financial crisis. For example, a five-year securitisation will still have a capital default charge of over 15%. This is as compared to a total accumulative default rate during the crisis (2007 to 2013) of only 0.14%.[8]

This has led to several calls for reform by stakeholders in a bid to encourage (re)insurers to return to ABS markets and diversify their investments which in turn would contribute to the stability and growth of the real economy.

## Impact of EU and UK Securitisation Regulations

As part of its legislative review of the EUSR, the European Commission carried out a targeted public consultation.[9] Subject to some limitations to do with the amount of time the framework had been in place and the existence of exogenous factors affecting the market, respondents said "*they did not witness a widening of the investor or issuer base… on the contrary, respondents stated that the number of investors from some major sectors, such as insurance companies, had decreased*".

Similar industry engagements also took place in the UK in 2021 when HM Treasury published a call for evidence seeking responses on how the UK Securitisation Regulation ("**UKSR**") could be improved and received similar responses to those received by the EU Commission on the EUSR. A number of respondents noted in particular that the UKSR had "*not managed to sufficiently broaden the investor base of securitisations, especially among insurance companies and insurance funds*".

Both the EU and the UK (as part of the Edinburgh Reforms) are now considering reforms of the Solvency II regulatory framework for insurers with the objective of fuelling more investments by insurers, including in securitisations, but through different regulatory mechanisms as discussed below.

## Direction of Travel of Solvency II in the UK and EU

### The UK

The UK Government considers the opportunity for insurance regulatory reforms to be one of the early gains of Brexit. HM Treasury and the Prudential Regulatory Authority ("**PRA**") are expected to take advantage of the post-

[8] https://www.theia.org/sites/default/files/2019-05/20150513-ecsecuritisationframeworkresponse.pdf

[9] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0517

Brexit legislative freedoms to develop a homegrown insurance regulatory regime which addresses the idiosyncrasies of British insurers.

They have proposed reforms to Solvency II, which will be renamed "Solvency UK". Some of these reforms include (i) a substantial reduction in the risk margin by around 65% for long-term life insurance business and 30% for general insurance business; (ii) a more sensitive treatment of credit risk in the matching adjustment portfolio; (iii) allowing for the inclusion of assets with 'highly predictable' cash flows in matching portfolios (although the expectation is that the majority of the portfolio would still consist of fixed assets), subject to a number of safeguards to be implemented by the PRA; (iv) removing the disproportionately severe treatment of assets in matching adjustment portfolios with ratings below BBB; and (v) introducing greater flexibility in the treatment of matching adjustment applications and breaches.

The inclusion of assets with 'highly predictable' cash flows in matching adjustment portfolios is potentially a game changer for insurers as investors, particularly as it relates to insurers' investments in securitisations. This reform has the potential to substantially increase (re)insurers' appetite for investing in securitisations of assets with prepayment features and unscheduled amortisation profiles such as residential mortgages and credit cards where portfolio performance backing the investment is arguably 'highly predictable' but not fixed in terms of timing and amount.

## EU Solvency II Reforms

Similar to the UK, the EU is considering changes to the Solvency II regime. These amendments are aimed at making the (re)insurance sector more resilient and prepared for future challenges, while stabilising insurers' capital requirements. In particular, proposals for reform include macroprudential tools which are likely to improve insurers' ability to withstand systemic shocks. However, no change is being considered to the existing matching adjustment rules and the fixity requirements, possibly because a vast majority of EU life insurers do not use this tool.

The EU is aware of the low level of securitisation investment by (re)insurers but Solvency II is not regarded as the problem. In October 2021, the EU Commission published a call for advice on the review of the securitisation prudential framework. In a joint response provided in 2022 that has been widely criticised, the three European Supervisory Authorities ("**ESAs**") concluded that the Solvency II framework did not seem to influence insurance activity in EU securitisations.

They found insufficient evidence to conclude that the current capital requirements for spread risk on securitisation positions under Solvency II are not fit for purpose. They therefore recommended that the prudential framework for insurers and reinsurers should be maintained as it currently stands. For more information, see the article entitled "*ESAs Joint Advice: a false dawn for the European securitisation prudential framework?*" earlier in this volume.

As a result of their conclusions, the ESAs' response made no proposals for how to stimulate EU (re)insurers' investments in securitisations. This may be short-sighted if there is a policy aim to encourage (re)insurer investment in securitisations, particularly as they acknowledge that there was no evidence to show that the current regulatory regime has helped to encourage insurers' investments in ABS assets.

The analysis by the ESAs appears to be flawed in a number of ways. One crucial flaw is that, in concluding that Solvency II is not the problem keeping (re)insurers out of the securitisation markets, the time series it examined failed to span the introduction of Solvency II. Instead, it started its analysis at the time Solvency II was already in place, meaning the effect of its introduction could not be inferred.

## Conclusion

The UK appears to be pro-actively proposing positive steps to encourage insurers' investments in securitisations, although there is still a need to revisit the prudential requirements for UK insurance companies' investments in securitisations. On the other hand, it does not appear that the reforms being proposed by the EU would create similar momentum. We continue to hope that the EU will revisit its proposed Solvency II reforms and consider changes to the regime to broaden the investment options of EU (re)insurers, including by making securitisation investments capital charges more risk sensitive.

In addition, we are aware that there has been some interest in marketing transactions to insurers considering acquiring matching adjustment-compliant securitisation assets. While there have been a few recent transactions, particularly relating to equity release mortgages, there is yet to be a public securitisation transaction in any of the major traditional asset classes which has been structured to comply with the matching adjustment requirements. We hope that the proposed revisions to the matching adjustment rules in the UK will serve as a catalyst for the introduction of matching adjustment-compliant public securitisation issuances in the UK across a wide range of asset classes.

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