

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

## **Introduction**

- 1.1. According to Article 16 of Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (hereinafter "EIOPA Regulation")<sup>1</sup>, EIOPA is issuing Guidelines on the treatment of market and counterparty risk exposure in the standard formula
- 1.2. These Guidelines relate to Article 104 and 105 of Directive 2009/138/EU 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 (hereinafter "Solvency II")<sup>2</sup> and to 164 to Article 202 of Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC (hereinafter "Commission Delegated Regulation 2015/35")<sup>3</sup>.
- 1.3. These Guidelines are addressed to supervisory authorities under Solvency II.
- 1.4. 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.
- 1.5. 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) 236/2012.
- 1.6. If not defined in these Guidelines the terms have the meaning defined in the legal acts referred to in the introduction.
- 1.7. These Guidelines shall apply from 1 April 2015.

### **Guideline 1 – Employee benefits**

- 1.8. Where liabilities for employee benefits are recognised in accordance with Chapter II of Commission Delegated Regulation 2015/35, undertakings should take them into account in the calculation of the capital requirements for counterparty default risk and market risk modules. For this purpose, undertakings should take into account the nature of the benefits and where relevant, the nature of all contractual arrangements with an institution for occupational retirement provision as defined by Directive 2003/41/EC or another insurance or reinsurance undertaking for the provision of these benefits.
- 1.9. If the management of the assets representing the liabilities for employee benefits has been outsourced, undertakings acting as a sponsor should take

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<sup>1</sup> OJ L 331, 15.12.2010, p. 48–83

<sup>2</sup> OJ L 335, 17.12.2009, p. 1-155

<sup>3</sup> OJ L 12, 17.01.2015, p. 1-797

them into account in the calculation of the capital requirement for market risk and counterparty default risk modules provided, they are liable for any loss in value of these assets.

### **Guideline 2 - Influence of call options on duration**

- 1.10. When determining the duration of bonds and loans with call options undertakings should take into account that they may not be called by the borrower in the event that its creditworthiness deteriorates, credit spreads widen or interest rates increase.

### **Guideline 3 – Average duration for the duration-based equity sub-module**

- 1.11. Undertakings should interpret the average duration referred to in Article 304 (1) (b) (iii) of Solvency II as the duration of the aggregated cash-flows of the liabilities.

### **Guideline 4 – Interest rate risk sub-module**

- 1.12. Undertakings should include all interest rate sensitive assets and liabilities in the calculation of the capital requirement for the interest rate risk sub-module.
- 1.13. 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 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.
- 1.14. 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.
- 1.15. 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 5 - Investments with equity and debt instrument characteristics**

- 1.16. Where assets exhibit debt and equity instrument characteristics, undertakings should take into account both of these features when determining which standard formula risk sub-modules should apply.
- 1.17. When determining which standard formula risk sub-modules apply undertakings should consider the economic substance of the asset.
- 1.18. 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.

- 1.19. Where it is not possible to consider the asset as the composite of separate components undertakings should base the determination of which of the standard formula risk sub-modules apply on whether the debt or equity characteristics predominate in an economic sense.

#### **Guideline 6 - Short equity positions**

- 1.20. Where undertakings hold short equity positions, they should only be used to offset long equity positions in the calculation of the capital requirement for equity risk if the requirements set out in Articles 208 to 215 of Commission Delegated Regulation 2015/35 are met.
- 1.21. Undertakings should ignore any other short equity position (residual short equity positions) in the calculation of the capital requirement for equity risk.
- 1.22. The residual short equity positions should not be considered to increase in value from applying the stresses to equities.

#### **Guideline 7 – Market risk concentration sub-module**

- 1.23. Without prejudice to Article 187 (3) second part of Commission Delegated Regulation 2015/35, undertakings should not assign a risk factor of 0 % to investments in entities which are owned by entities included in the list set out in Article 187 (3) of Commission Delegated Regulation 2015/35.

#### **Guideline 8 – Securities lending transactions and similar agreements**

- 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.
- 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.
- 1.26. If the received asset is recognised and the lent asset does not remain on the balance sheet, undertakings should:
- (a) apply the relevant market risk sub-modules to the received asset;
  - (b) take into account the lent asset in the calculation of the capital requirement for counterparty default risk on type 1 exposures based on the balance sheet value of the lent asset at the time of the exchange, if the contractual terms and the legal provisions in the case of an

insolvency of the borrower give rise to a risk that the lent asset is not returned although the received asset has been handed back.

- 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.

### **Guideline 9 – Commitments which may create payment obligations**

- 1.28. As provided for in Article 189 (2) (e) of Commission Delegated Regulation 2015/35 the capital requirement for type 1 exposures in the counterparty default risk module should be applied to legally binding commitments which an undertaking has provided or arranged.
- 1.29. When 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 amount.
- 1.30. The estimated nominal value is the maximum amount that is expected to be paid in case of a credit event of the counterparty.

### **Compliance and Reporting Rules**

- 1.31. This document contains Guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16 (3) of the EIOPA Regulation, national competent authorities shall make every effort to comply with guidelines and recommendations.
- 1.32. Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.
- 1.33. Competent authorities shall 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.
- 1.34. 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 Reviews**

1.35. The present Guidelines shall be subject to a review by EIOPA.