Debevoise & Plimpton

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Proposal for Solvency II Regulation—Finally a Functioning Classification for Insurer's Long-Term Equity Investments?

11 September 2025

Background

In January this year, the EU adopted an Amendment Directive[1] to the Solvency II Directive[2], which will take effect on 30 January 2027. Solvency II regulates EU insurers' capital requirements, and the Amendment Directive revises the capital treatment of long-term equity investments held by EU insurers. Since its inception, Solvency II has included onerous prudential capital requirements for insurers that hold equity investments. The relevant risk module of Solvency II requires insurers to "shock" the market value of their equity investments with stress factors of 39% for listed ("type 1") and 49% for unlisted ("type 2") equities, making equity investments capital intensive.

A further revision of Solvency II Regulation[3] in 2019 introduced better treatment for insurers' long-term equity investments, reducing the stress factor for those investments to 22%, provided the investments were matched to a portfolio of ring-fenced and separately managed insurance liabilities. This new treatment was not widely adopted, because forming the ring-fenced portfolio of liabilities was extremely difficult, if not impossible, under the accounting standards of some member states.

EU legislators have addressed this problem by including new provisions on long-term equity investments in the revised Solvency II Directive and changing the conditions to make the application of the rules more practical. Certain details of the treatment are covered in the Solvency II Regulation,[4] for which the European commission published a draft proposal in July (the "Proposal").

Furthermore, EU legislators have recognised that the prudential capital treatment for securitisations was set too harshly, partly in the wake of the 2008 financial crisis. As part

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[1] Directive (EU) 2025/2

[2] Directive (EU) 2009/13/EU

[3] Regulation (EU) 2015/35

[4] Regulation (EU) 2015/35

of a comprehensive package to revitalize the European securitisation market described in a previous client update, the Proposal also seeks to amend and soften the prudential capital treatment for securitisations.

Revised Long-Term Equity Investments

According to the revised Solvency II Directive, the reduced stress factor of 22% is available for a separately managed portfolio exclusively of equities listed in the EEA or OECD, or unlisted companies with their head office in the EAA or OECD, provided the portfolio is appropriately diversified and the insurer intends to hold the equities for more than five years. Under the Proposal, matching the equity portfolio to a ring-fenced and separately managed portfolio of insurance obligations will no longer be required. Instead, the insurer must demonstrate that it is able to avoid "forced" sales of equities under stressed conditions in this portfolio for a period of five years, half of the currently applicable 10-year period.

The Proposal sets out detailed requirements on how the insurer demonstrates its financial resilience to avoid the need for forced sales. The options include demonstrating that the insurer has sufficient illiquid life insurance liabilities and that exceed ten years, holding a sufficient liquidity buffer for non-life insurance obligations or, alternatively, showing it can withstand market stress without forced selling, based on risk tolerance limits, an appropriate margin of prudential capital in excess of the solvency capital requirement and a projected excess of cash inflows over outflows for 5 years under normal and stressed conditions.

Of particular importance for fund managers is that the reduced stress factors can also be applied to equities held in the portfolio of certain investment funds, provided the requirements described above for the long-term equity investments are fulfilled **at fund level**, and not at the level of each individual equity investment in the portfolio. Currently, funds that benefit from this fund level assessment are ELTIFs, EuVECAs, EuSEFs and unlevered, closed-ended EU AIFs. This is the same list of types of funds eligible for privileged treatment under the Solvency II Regulation, re-classifying those funds' unlisted (normally type 2) equity investment into type 1 equity investments with a stress factor of 39% instead of 49%.

The Proposal retains most of the types of funds eligible for this relief but makes one key change. Unlevered, closed-ended EU AIFs remain eligible, provided they are managed by an authorized EU AIFM. Funds managed by sub-threshold AIFMs or EU funds managed by non-EU managers are no longer included. Note that the Proposal does not also amend the Solvency II Regulation and its list of funds eligible for the lower stress factor.

The Proposal further clarifies that, even when the requirements of the long-term equity model are assessed at fund level, the 22% stress factor should be applied to each equity position in the fund's portfolio, in line with the look-through approach applied to holdings in funds under Solvency II. Where the insurer cannot obtain sufficient data on the underlying portfolio, the 22% stress factor can be applied to the interest in the fund instead of the equities in the fund's portfolio.

Given the difficulty in assessing compliance with the long-term equity investment requirements on an asset-by-asset basis when investing in a "blind pool" private equity fund, it is disappointing that the simplified assessment at fund level is not possible for a broader range of funds. In particular, closed-ended EU AIFs are only eligible if they are unlevered. As the leverage calculation under AIFMD can be quite restrictive, this may unnecessarily exclude funds with substantially the same risk profile. For instance, funds that borrow to bridge capital calls where the borrowing remains outstanding for more than a "short-term" period may technically qualify as levered, and do not benefit from the relief, although these funds are not noticeably more risky than unlevered funds

Current requirements	**Requirements under revised Solvency II Directive and Proposal**
Sub-set of equity investments listed in EEA/OECD or unlisted and headquartered in EEA/OECD	Sub-set of equity investments listed in EEA/OECD or unlisted and headquartered in EEA/OECD
Such sub-set permanently assigned to cover portfolio of insurance obligations of one or more businesses and managed separately from other activities	
Average holding period exceeds 5 years	Average holding period exceeds 5 years
	Sub-set is diversified to avoid accumulation of exposure to issuers or risk profiles
Insurer is able to avoid fire sales for **10** years on ongoing basis / under stressed conditions	Insurer is able to avoid fire sales for **5** years on ongoing basis / under stressed conditions

	Procedures how to demonstrate ability to avoid fire sale alternatively based on illiquidity/duration of insurance obligations and liquidity buffer or cashflow projections under normal and stressed conditions
Such requirements are assessed at fund level if investments are held in ELTIFs, EuVECAs, EuSEFs or closed-ended, unlevered EU funds	Such requirements are assessed at fund level if investments are held in ELTIFs, EuVECAs, EuSEFs or closed-ended, unlevered EU funds **managed by authorised EU AIFMs**

Equity Investments Under Legislative Programmes

The Proposal envisages introducing privileged treatment for equity investments under a "legislative programme", which is a scheme providing financial resources in the form of subsidies and guarantees subject to oversight by a national or regional government in the EU, the European Commission, or their agencies or bodies, e.g., EIF programmes. If the insurer invests in equities in companies backed by such a scheme, the insurer benefits from reduced capital requirements equivalent to the company's reduction in credit risk. There is an exclusion for *ad hoc* interventions in individual situations and programmes targeting the whole economy. Provided the programme meets certain criteria and reduces the insurance undertaking's credit risk by at least 5%, the prudential capital requirement for the equity investment can be reduced by the same percentage. This applies to direct investments as well as to investments made through investment funds.

Securitisations

The provisions on equity risk and spread risk are updated. Defaulted and forborne loans are no longer supposed to be subject to the "spread risk module" but will be moved to counterparty default risk.

Most notably, the Proposal overhauls the prudential capital requirements for investments in securitisations.[5] Securitisations currently form a specific category of "spread risk" and are treated more conservatively than regular bonds or loans. Generally,

[5] As defined in the EU Securitisation Regulation (EU) 2017/2402.

a stress factor is allocated based on duration and, where available, credit rating by a recognized rating agency. However, the applicable stress factors differ significantly, depending on additional criteria. So-called “simple, transparent, and standardized (“STS”) securitizations”, a category of “high-quality” securitisations available only for EU structures, are further separated into senior and junior positions, and benefit from significantly lower stress factors than other securitisations. Securitisations which do not have a credit rating and re-securitisations are treated particularly harshly.

The Proposal envisages reducing the stress factors applicable to both senior and junior STS-Securitisations which have a credit rating. It also provides for a significant improvement for non-STS securitisations with a rating: Currently, the prudential capital requirements for this type of securitisation are punitive. The current rules make no distinction between senior and junior positions and non-STS securitisations are subject to severe stress factors depending on rating and duration. The Proposal now puts forward relief for rated non-STS secutitisations, by introducing separate categories for senior and junior positions, with reduced stress factors for both. The reduction is not consistent throughout the spectrum of rated senior and junior positions. With a few outliers, in broad terms, the stress factor for rated senior positions is around four to five times lower than the current factor. For rated junior positions the stress factors are intended to be reduced by between 40% and 60%, with some outliers. Despite these changes, the prudential capital requirements for ordinary loans and bonds remain significantly more advantageous. The Proposal does not set out any improvement for securitisations without ratings or re-securitisations.

Category	Current	Proposal
Rated senior STS securitisation position	Stress factor dependent on rating and duration	Reduction of stress factor
Rated junior STS securitisation position	Stress factor dependent on rating and duration (higher than senior position)	Reduction of stress factor
Unrated STS securitisation position	Stress factor dependent on duration, no changes proposed	
Rated non-STS securitisation position	Stress factor dependent on rating and duration	Significant reduction of stress factor for senior position

		Reduction of stress factor for Junior position
Re-securitisation	Punitive stress factor dependent on rating and duration, no changes proposed	
Unrated non-STS securitisation position	Stress factor of 100%, no changes proposed	

Next Steps

The Proposal is under consultation and feedback will feed into a draft proposal expected in Q3 of 2025.

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Please do not hesitate to contact us with any questions.

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