DET KONGELIGE
FINANSDEPARTEMENT

Royal Ministry of Finance

The Minister of Finance

Commissioner Michel Barnier
European Commission
B-1047 Brussels
BELGIUM

Dear Michel

Your ref	Our ref	Date
	09/5026 -	29.08.2014

Credit exposures to regional governments and local authorities under Solvency II

I understand that the Commission intends to adopt the Solvency II delegated acts this September, and I have noted that in the draft delegated acts distributed to the members and observers of the Commission Expert Group on Banking, Payments and Insurance on 1 August 2014, some amendments had been made in order to enhance consistency with rules in the banking sector. The Norwegian Ministry of Finance welcomes measures for increased consistency with the banking sector. I will in this letter propose another amendment which will contribute to improving said consistency in countries that have implemented a 20 per cent risk weight for credit institutions' exposures to regional governments and local authorities (RGLAs), as well as to strengthen the risk sensitivity and prudence of the Solvency II framework.

The proposal concerns the Solvency II capital requirement for credit exposures to unrated regional governments and local authorities (RGLAs). A similar proposal was made by the Ministry and the Financial Supervisory Authority of Norway in the context of the Expert Group on Insurance Solvency on 16 March and 6 April 2011.

Pursuant to Article 109a of the Solvency II directive, as amended by the Omnibus II directive, credit exposures to RGLAs shall be treated as exposures to the central government of the jurisdiction in which they are established, provided that there is no difference in risk between such exposures because of the specific revenue-raising powers of the former, and specific institutional arrangements exist, the effect of which is to reduce the risk of default. Otherwise, exposures to unrated RGLAs shall be treated as exposures to any other unrated issuer.

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A similar provision applies for credit institutions in Article 115 of Regulation (EU) 575/2013, which continues provisions in Annex VI Part 1 of Directive 2006/48/EC. The main alternative to treatment as exposures to central governments is treatment as exposures to other institutions. These legislative acts do, however, also allow for *an intermediate treatment of RGLA exposures*, whereby such exposures may be assigned a risk weight of 20 per cent if they are denominated and funded in the domestic currency of the RGLAs. When Directive 2006/48/EC was implemented in Norway, it was concluded that there is a difference in credit risk between Norwegian RGLAs and the central government, and that it therefore would not be appropriate to treat the RGLA exposures similar to central government exposures. This difference in credit risk is, however, considerably smaller than the difference in credit risk between the central government and institutions or other issuers. An intermediate treatment is therefore considered suitable for Norwegian RGLAs, and applied in Norwegian regulations.

Norway has actively promoted – and contributed to the proposal and adoption of – the allowance for an intermediate treatment of RGLA credit exposures in the afore-mentioned credit institution legislation. This effort was prompted by the credit risk characteristics of Norwegian RGLAs and our view on RGLA credit risk in general. Moreover, insurance undertakings in Norway are (until the Solvency II rules enter into force) also subject to the capital requirements for credit institutions, including the intermediate treatment of RGLA credit exposures. This is in part owed to the presence in Norway of several financial groups encompassing both credit institutions and insurance undertakings, and an objective to minimise the potential for regulatory arbitrage.

In the current texts of the Solvency II framework, i.e. the adopted directives and the draft delegated acts, there is no allowance for an intermediate treatment of unrated RGLA credit exposures. If the approach currently foreseen in the draft delegated acts is maintained, there will be an unfortunate inconsistency between the regulatory regimes for credit institutions and insurance undertakings, which may have adverse effects in markets and institutions. In Norway, RGLAs are predominately unrated. I therefore expect insurance undertakings to reduce their exposures to the RGLAs considerably, and seek other investments with a better balance between actual risk and capital charge.

Although I acknowledge that a full harmonisation of the treatment of RGLA credit exposures between the two regulatory regimes is neither feasible nor desirable, as the credit institutions regime does not reflect the effect of exposure duration on market risk, I strongly believe that the Solvency II framework would be improved by introducing an allowance for an intermediate treatment of RGLA credit exposures. I propose an amendment to the draft delegated acts establishing that *credit exposures to unrated RGLAs shall be treated as exposures with a credit quality step one step above the credit quality step of the central government* of the jurisdiction in which they are

established. For sake of consistency within Solvency II, this measure should also be applied for concentration risk, as well as spread risk. I enclose a concrete proposal for the amendment, based on the draft delegated acts distributed on 1 August 2014.

The effects of my proposal on capital charges for unrated RGLA credit exposures (not treated as exposures to the central government) are illustrated and compared in table 1 below. If there is no intermediate treatment for unrated RGLAs, as currently foreseen in the draft delegated acts, the capital charge will be between 3 and 30 per cent for durations between 1 and 15 years, see the first column under the Solvency II banner in the table. The next two columns present the capital charges under my proposal. For credit exposures to RGLAs in jurisdictions with AAA-rated central governments, my proposal implies capital charges of roughly one third of the capital charges in the case of no intermediate treatment. Lower-rated central governments implies higher capital charges for the RGLA exposures, see the next column for the case of AA-rated governments. In contrast, the far right column presents the static and relatively low capital charge for such exposures according to Regulation (EU) 575/2013 and Directive 2013/36/EU (the CRR/CRD IV framework) for credit institutions.[1]

Table 1. Capital charges for unrated RGLA credit exposures not treated as exposures to the central government (per cent of exposure).

Duration (years)	*Solvency II*			*CRR/CRD IV treatment*
	No intermediate treatment	*My proposal & AAA-rated central government*	*My proposal & AA-rated central government*	
1	3.0 %	1.1 %	1.4 %	2.7 %
5	15.0 %	5.5 %	7.0 %	2.7 %
10	23.5 %	8.5 %	10.5 %	2.7 %
15	29.5 %	10.9 %	13.0 %	2.7 %

Source: Financial Supervisory Authority of Norway

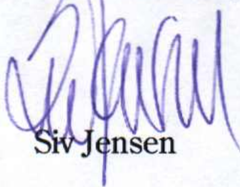
In my view, this amendment will contribute to improve the consistency between the Solvency II and CRR/CRD IV frameworks in countries that have implemented a 20 per cent risk weight for credit institutions' exposures to RGLAs, and thus weaken incentives for regulatory arbitrage in investment allocations. I refer in particular to Articles 115

[1] The capital charge is dependent on the application of buffer requirements in Directive 2013/36/EU, as well as the use of the aforementioned intermediate treatment of RGLA exposures in Regulation (EU) 575/2013. With a combined buffer requirement of 5.5 per cent, as is currently in place in Norway, the capital charge is 2.7 per cent of the exposure value.

and 121 of Regulation (EU) 575/2013. Moreover, the proposed amendment fits well into the Solvency II general approach to spread risk, and it will strengthen the risk sensitivity and prudence of the Solvency II framework.

I hope that the Commission will consider this proposal before finalising the Solvency II delegated acts.

Yours sincerely,



Siv Jensen

1 enclosure

Copy: The Financial Supervisory Authority of Norway

Enclosure **Proposal for amendment to the Solvency II draft delegated acts**

The Norwegian Ministry of Finance proposes the following amendment to the Solvency II draft delegated acts. The amendment is indicated by underlined text, and is made with reference to the draft delegated acts distributed to the members and observers of the Commission Expert Group on Banking, Payments and Insurance on 1 August 2014.

REGIONAL GOVERNMENTS AND LOCAL AUTHORITIES

Article 85

1. The conditions for a categorisation of regional governments and local authorities shall be that there is no difference in risk between exposures to these and exposures to the central government, because of the specific revenue-raising power of the former, and specific institutional arrangements exist, the effect of which is to reduce the risk of default.
2. Other regional governments and local authorities, for which a credit assessment by a nominated ECAI is not available, shall be treated as exposures with a credit quality step one step higher than the credit quality step assigned from the rating of the central government of the jurisdiction in which they are established.