Solvency II revision: long-term investment challenges

Gabriel Bernardino

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The role of insurers in building a stronger and sustainable Europe post COVID-19

The insurance sector plays a fundamental role managing risks from citizens and businesses and mobilising savings and investing them, thus developing the European economy and stimulating growth. The sector represents some of Europe's largest institutional investors and, in line with the nature of its liabilities, acts as a long-term investor.

In this sense, the insurance sector is key to achieving the objectives of the Capital Markets Union (CMU). As Europe's largest institutional investors, insurers have the financial strength to provide widespread benefits for the economy, acting in a counter-cyclical manner and investing with a sustainable, longer term perspective.

This role of insurers will be crucial for the European economic recovery post COVID-19.

Insurers are currently facing a 'low for long' interest rate scenario and Solvency II needs to reflect this new market reality. In this environment, the risk of adverse returns is gradually being transferred from the insurer to the policyholder by shifting the supply of insurance products from those with guaranteed returns to so-called unit linked products.

In this context, the 2020 Solvency II review should seek to strike a better balance by fully exploring the scope for differential treatment of liabilities according to their liquidity, and for the capital requirements of assets also to better consider the liabilities which they back. The assets backing illiquid liabilities are less vulnerable to short term fluctuations in market values. Recognising that feature will improve the risk-sensitivity of the framework and facilitate long-term guarantees and long-term productive investments.

EIOPA is currently testing a more favourable, yet prudent, treatment of long-term and illiquid liabilities compared with those of shorter duration, and the assets that back them, in particular long term equity.

On the volatility adjustment, an area for review is the recalibration of application ratios with the aim that insurers are rewarded for holding illiquid liabilities rather than being penalised for holding liquid liabilities.

On the risk margin, EIOPA is exploring ways to reduce its size and volatility, especially for the long term liabilities, based on the fact that the future capital requirements are not fully independent.

With regard to equity risk, EIOPA is testing the criteria for the ability to hold equity long-term, by making a link with long-term illiquid liabilities and taking into account that equity investments are managed on a portfolio basis rather than on an individual asset basis.

These adjustments are intended to improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments. In this way, the insurance sector will be better placed to invest with a sustainable, longer-term perspective which, in turn, will boost growth for Europe's economy and provide better perspectives for Europe's long-term savers.

In a post-COVID-19 world, long term investment is more important than never. Insurers can and will play an important role in the building up of a stronger and sustainable Europe. ●

Clément Michaud

Chief Financial Officer, Crédit Agricole Assurances

Choices to make for the European Commission

At the end of the year, when the Commission will draft its review of the Solvency II directive, it should ask itself the right questions.

Over the past quarters, the Solvency II framework has shown its structural weaknesses. Indeed, the directive acts as a pro-cyclical tool, with volatile solvency ratios, which forces companies to immediately sell long-term assets to preserve their equity ratio. Insurance is intrinsically a long-term business. Solvency 2 is short sighted by assessing a long-term financial environment with a mark-to-market approach. Moreover, the consequences of the accounting standards IFRS 9 and IFRS17 might negatively impact the long-term positioning of the sector. ▶

The Commission, especially in a negative rate environment that requires major changes for the profession, should use a framework that encourages the insurers who commit to long-term financing and reduces volatility, by introducing tools such as dynamic VA for standard formula, or market assumptions based on historical average values instead of spot values. The Commission should resist to any change that increases capital needs by more strident prudential rules, which are encouraged by EIOPA.

To pursue the ambitious roadmap for the years and decades to come, drafted by Mrs. von der Leyen, in which the transition towards a carbon-neutral economy and digitalization are emblematic objectives, all stakeholders should act along the same lines. With the right Solvency II framework, we are convinced that insurers could play a key role in this transformation.

For a stronger Europe, we should also be more realistic regarding the international markets. Regulators in other countries sometimes seem to prioritise the functioning of their economy over the implementation of international accounting or prudential norms. As an example, IFRS17 will not be applied everywhere, which will be detrimental to the EU companies in the global market place. Therefore, we should use our time to consolidate our current standards through a qualitative rather than a quantitative exercise.

Therefore, our recommendations to the Commission are three-fold:

- Preserve the stability of the European prudential framework. The directive review is crucial in this respect. There is no need to put in question the entirety of Solvency II but to correct shortcomings towards a less volatile system. For example, the dynamic VA should be extended to the standard formula. Likewise, implementing other new norms in parallel such as IFRS17 that aggregates the same inconveniences should be avoided.
- Evaluating the anticipated benefits of the proposed regulatory changes for the long-term funding of our economy and proposing easy-to-implement measures in this realm.
- Consider that additional capital charges is not the most appropriate solution to solve problems. The Coronavirus pandemic causes dire economic challenges and demonstrates that the EU economy requires stabilisers and the insurance sector is definitely one of them.

The shock absorption will require time, yet the success of European programmes and projects passes by a robust insurance market which is able to overcome and foresee beyond the current turbulence.

Cyril Roux

Chief Financial Officer, Groupama

Who's to decide how to invest insurers assets?

Much has been written about the way insurers should invest the funds they receive from their policyholders. Viewpoints differ, based in particular on the stakeholders most prominent in the mind of the respondent. For insurance regulators, the primary stakeholders of insurance undertakings are the policyholders: monies should be invested by insurers in order to safeguard policyholders' interests. This is akin to the view of asset managers and their regulators. In their minds, fiduciary duty trumps other considerations and investors' interests should come first.

In this worldview insurers are financial intermediaries managing policyholders' money and are answerable to them. On the other end of the spectrum, fractions of national and European political forces view insurers' balance sheets as too large not to try and commandeer for macroeconomic purposes. Insurers should thus be incentivized or brought to invest in the asset classes deemed most useful for European or national policy-making – if not taxed altogether.

In European circles, these asset classes include infrastructure and Green deal investments. The French government focuses on equity financing of local start-ups and equity stakes of French listed companies, so as to avoid foreign takeovers, neuter American activists, and ultimately maintain the State's ability to weigh on business decision making, including the number of staff employed domestically. Left unsaid but weighing prominently on insurers' balance sheets is the financial repression leading to the large overweight of sovereign credit thanks to its nil capital charge under solvency II. This plays out very differently by country: the Italian life insurance industry would be crippled by the eventual restructuring of the BTP, whereas the solvency of the German one depends on the eventual "return of the return" (on its sovereign holdings).

The bank-sovereign loop hasn't been much defused, but the less commented insurance-sovereign loop is also severe. To escape the heavy, shifting and sometimes contradictory regulatory and political interventions, and to steer their clients towards products with positive expected real returns, while alleviating solvency requirements, life insurers have touted unit-linked products in lieu of with-profit funds or "gestione separata". In so doing they give their clients a financial education similar to that given by asset managers, adding the insurance cover (such as annuities in the decumulation period) and the associated costs.

While the costs are mingled and opaque in traditional life insurance, they are separate and visible in unit-linked products. While decried, costs associated with intermediation and advice, asset-liability management, data, research, portfolio management, execution, servicing, risk management, compliance, reporting and disbursements have to be borne by the client.

This reality must also form part of the education of the clients who entrust their funds to financial intermediaries.

Mireille Aubry

Head of Prudential Regulation Standards & Foresight, COVEA

Making a clear distinction between liquidity and solvency in the Solvency II 2020 Review

The overweighting of liquidity needs is a major bias that is a source of dysfunction in the Solvency II regime. It is the result of a failure to adequately take into account the going concern perspective of the insurance undertaking as well as a lack of recognition of the key role own funds play in the management of liquidity risk itself.

A good liquidity ratio does not guarantee good solvency. Conversely, there is a positive impact of the solvency ratio on liquidity. These two observations alert us to the importance of distinguishing between liquidity and solvency and the non-reciprocal influence of one on the other. It should be remembered that the need for liquidity is not a major risk for an insurer (unlike a bank), which benefits from stable and long-term resources that are also based on a reverse production cycle. The insurer collects insurance premiums before any commitment to pay guarantees, and payments are positioned at maturities that can be very distant. In this respect, it should be noted that the risk of massive surrenders is particularly over-estimated in Solvency 2, in disconnection with the historical series of surrenderable contracts and statistics including during the last financial crisis. Finally, it should be noted that the surrender risk, where it exists, may be greatly reduced by the presence of discretionary profit sharing released in case of lapses.

Besides, an overweighting of liquidity can be a source of under-optimisation of overall financial performance. This under-optimization constitutes a risk that negatively impacts the insurer's future profitability and solvency as well as the performance of the guarantees offered to policyholders and is potentially very significant in the long term.
Insurance undertakings' own funds constitute a provision of liquidity in the event of unexpected adverse events that could potentially increase cash outflows, particularly in relation to policyholder liabilities. In the context of a general asset, in addition to directly absorbing losses and thus providing liquidity by absorbing losses, own funds are represented by assets whose regular inflows (coupons, dividends, rents, redemptions, etc.) also provide liquidity to avoid forced sales of assets representing best-estimate provisions in the event of contingencies on the outflow date of payment flows related to insurance liabilities. In a total balance sheet approach, where the assets representing own funds are themselves subject to a risk and capital requirement calculation (recursive loop), it is extremely important to include own funds in all their dimensions and to recognise their contribution to the management of the liquidity risk of commitments.

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Own funds also change the "volume of technical provisions" by taking on a role of provisioning for "unexpected" losses. It should be noted that, even if the calculations of required capital are based on "instantaneous" shocks, this set of losses in no way corresponds to an immediate cash outflow, but has a run-off period close to that of best-estimate provisions, or even longer in the case of non-life companies, where the run-off period of best-estimate provisions is itself truncated and does not reflect their much longer actual duration as a going concern. ●

Martin Merlin

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Removing regulatory obstacles to insurers' contribution to a sustainable growth

The European Commission is committed to lead the global effort to fight against climate change. Our European Green Deal aims to make the EU the world's first climate-neutral continent by 2050. To achieve our ambitions of a sustainable economic growth, Europe needs more stable capital in order to finance energy infrastructure, environmental-friendly facilities, eco-innovation technologies, but also research and development, which can boost growth, innovation and competitiveness.

With trillions of assets under management, the insurance sector is a mainstay of the European financial industry. Due to the long-term nature of their liabilities, insurers can contribute to the European Green Deal and the Capital Markets Union. ▶

The new Commission is committed to identifying the barriers that are keeping insurers' allocations to long-term investments low, and to determining which policy levers can help overcome these barriers. In this regard, some stakeholders claim that the prudential framework has fostered insurers' short-termism in investment decisions.

On the other hand, the downward trend of investments in long-term assets dates back to the late 1990s, and therefore cannot be only driven by prudential rules, as confirmed by recent studies on insurers' investment behaviour.

In fact, the prudential regulation should neither unduly favour nor hinder long-term investment, but provide the right incentives for robust risk-management while avoiding excessive risk-taking. Last year, the European Commission amended Solvency II to lower capital requirement for long-term investments in equity, including in small and medium sized enterprises, provided that insurers have implemented appropriate asset-liability management.

In the context of the forthcoming broader review of the Solvency II Directive, the Commission will further explore whether the prudential framework appropriately reflects the long-term nature of the insurance business, and whether it influences insurers' long-term and sustainable investment behaviour.

The European Commission will have to "green" all European legislation, by leveraging on the EU taxonomy.

This assessment should not be limited to a mere discussion as to whether capital charges on investments – be they green or long-term – should be reduced, although this is of course part of the debate. In fact, under the current uncertain financial conditions, insurers' ability to contribute to our political objectives may depend more heavily on whether the prudential framework is efficient in mitigating the impact of short-term market volatility on insurers' solvency position. The review of the so-called "long-term guarantee measures" should therefore play a pivotal role in future debates.

In any case, in view of the high volatility of equity investments, as currently observed with the Covid-19 crisis, European regulators should carefully consider financial stability implications of any further capital relief on long-term investments, which would not be supported by quantitative evidence.

Reviewing the prudential framework will not be sufficient to achieve our climate objectives. The European Commission will have to "green" all European legislation, by leveraging on the EU taxonomy currently under development, in order to support insurer's effective contribution to the financing of the shift to a low-carbon economy and a sustainable growth.

Ilijana Jeleč

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Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

Financial sector as a key driving force in achieving EU sustainability goals

The financial sector has a key role in achieving the EU's overall sustainability goals through its demand-side investment potential on one hand, and creation of supply in the form of product development based on environmental and social factors on the other hand. The European Commission has adopted the Action Plan: Financing Sustainable Growth as a preparation for the future that ensures stability, a healthy planet, fair, inclusive and resilient societies and prosperous economies.

As early as 2014, European regulators set a milestone through the Non-Financial Reporting Directive, which requires the largest, as well as public-interest entities, to publish non-financial data related to environment and social responsibility. This seeks to achieve transparency in managing sustainability risks, given the growing demand for financial products that take into account social and environmental aspects of the investment. An additional boost for investing in sustainable projects will be the introduction of an EU taxonomy, as well as an agreement on green and brown taxonomies that will facilitate investor evaluation of projects in terms of sustainability.

We need a broad base of interaction oriented towards innovation to achieve long-term sustainable solutions.

The insurance industry helps the community understand, prevent and mitigate risks, including those associated with natural disasters and climate change, by taking on and managing them. On the other hand, the demand of insurance and pension funds as a reflection of the desire

to achieve long-term and stable returns with significant capital potential is at the same time a considerable challenge. Therefore, it is not surprising that Solvency II, as the basis of the regulatory and supervisory framework for the insurance industry, directs a significant part of it towards sustainability issues.

Supervisors have already started directing the industry towards anticipating, in particular, climate change

risk, through guidelines and recommendations on the use of scenario analyses in the underwriting system and risk management system through the ORSA process. What lies ahead is a detailed exploration and analysis of ways to better assess and integrate environmental risks into supervisory processes and practices, while the future supervisory efforts should focus on improving the quantity and quality of disclosed information, which may in part encourage the changes in investor practices. At the same time, the establishment and operation of green financial markets should continue to be promoted and facilitated as they do not retain their focus solely on creating value for shareholders, but extend it to all stakeholders by promoting the economic, environmental and social aspects of investments.

Government policies aimed at promoting sustainability, establishing a tax relief system and removing barriers to investment in sustainable projects and innovative and new technologies are also indispensable. In the perspective of complexity and breadth of sustainability dimensions, we need a broad base of interaction oriented towards innovation to long-term sustainable solutions, in which each member of the financial sector plays a role in the transition to a sustainable and prosperous economy, environment and society.

Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IVASS)

EU insurance firms and their expected role to channel premiums into long-term savings

In line with its traditional objectives, insurance is a process providing efficient protection against risks. In this context, insurance firms can certainly represent a driver for long-term savings and a mechanism for a stable and sustainable funding of the economy. However, we can neither expect that insurance plays a role in transforming short-term savings into long- term investments, nor in supporting the economy without a proper assessment of the associated investment risks.

Any financial mediation role of insurance should always be the product of a sound insurance process and should not become an objective per se. We have to acknowledge, however, that regulations might not always strike the right balance between prudential objectives and social and economic ones. Solvency II is a good prudential framework, but some consider it an obstacle to the release of financial guarantees and to the investment in long-term assets, particularly in the current scenario of low interest rates.

My view is that the Solvency II framework relies on features, such as the market consistent valuation, that we should not abandon, as they ensure proper and early risk identification and assessment. At the same time, however, the framework needs adjustments to avoid unduly penalizing long-term business. The first adjustment relates to the need to reduce balance sheet volatility, which could produce solvency indicators that do not reflect the long-term nature of the business.

The review of LTG Solvency II measures should allow increased stability of the balance sheet without jeopardizing the predictive characteristics of its indicators. Elements like the Volatility Adjustment, for example, should be better designed to reflect the capacity of firms to protect themselves from short-term spread volatility and to earn a risk premium on longer durations, avoiding unjustified capital relief.

Another area for improvement is the elimination of any undue capital charge penalization. Much has already been done in this field, but proper calibration needs an on-going monitoring and regulators should regularly review their conclusions in line with market developments. At the same time, a proper risk measurement should always inform the definition of financial requirements. Also proper capitalization is key for long-term business. The revision of interest rate capital charge is necessary in this regard.

Besides prudential regulation, insurance product design too is relevant in order to foster long-term guarantees and investments. For example, increased flexibility in the allocation of profits in certain life contracts or the increase of the illiquidity features of certain contractual liabilities could represent important factors to sustain long-term business.

> *Any financial mediation role of insurance should always be the product of a sound insurance process.*

Finally, we should not forget that a number of other factors not related to the regulation are also necessary. For example, the availability of well-structured long-term financial instruments in transparent markets is a precondition for incentivizing insurers to invest in long-term assets. Prudential regulations can only be part of the solution.

It is certain, however, that the focus should be centered on solutions that could soften, within prudential limits, the impact of the current low interest rate scenario on insurers and allow them to continue to play their role as providers of protection and long-term investors. A regulatory approach that simply provides disincentives to the release of long-term financial guarantees is not, I think, a desirable solution.

Petra Hielkema

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Finding the right balance: market valuation versus long-termism

There is a broad agreement that insurance companies play an important role in facilitating the real economy. With assets under management equal to EUR 11.5 trillion, or around two-third of the European GDP, their investment base is large. Given that insurers can invest over the life cycle these parties are regarded as important providers of long-term financing to governments, companies and financial institutions. However, we must be aware of the key role of insurance companies: to help policyholders manage their risks efficiently through the provision of a variety of insurance products. In a discussion on enabling insurance companies' long-term and equity role one should not ignore this. This brings me to the regulatory framework Solvency II and its main role: policyholder protection.

One big achievement of Solvency II is mark-to-market balance sheet valuation. While this forces institutions to be more concerned with short-term market movements, it is an important condition for proper risk management. Without mark-to-market valuation, the economic position of insurance companies is not fully reflected in their regulatory ratios and this becomes especially worrisome in a gone concern situation. Therefore, the alternative of having no mark-to-market valuation could be worse. This, however, clearly shows the trade-off. On the one hand, market valuation is an important condition for proper risk management and policyholder protection. On the other hand, the long-term investment horizon of insurers is not fully supported by mark-to-market valuation. In that sense, it is about finding the right balance.

There are some considerations that I would like to share in this regard. Firstly, the achievements of Solvency II so far. As mentioned previously, one big achievement is the introduction of mark-to-market valuation. A limitation is the potential short-termism that is inherent to market valuation. The Long-Term Guarantee package that was introduced with Solvency II provides a counteracting force by reducing the volatility in the Solvency II ratios, thereby acknowledging the role of insurers as long-term investors. Second, the aim of Solvency II. Its aim is not to steer the investments by setting capital requirements. The current discussion on supporting financial institutions' lending to green finance provides a nice example.

While I am fully supportive of the goal to create incentives for green finance, this should not happen at the cost of policyholder protection. Relieving capital requirements for insurers' green exposures may indeed provide a good stimulus in greening the system. However, as there is currently no evidence that green assets are less risky, this undermines the concept of a risk-based framework and potentially increases risk at the cost of policyholder protection. And as concluded by EIOPA in their recent Opinion on Sustainability within Solvency II, EIOPA did not receive any evidence that the Solvency II framework provides a disincentive that hinders investments in sustainable assets. That brings me to my last point.

Third, a broader perspective on investment opportunities. Insurers are indeed important providers of funding to the economy. The discussion is often focused on enabling insurers' role as equity investors, while it should be seen in a broader perspective. There are more opportunities, e.g. the provision of direct loans, for example mortgages, that will fit the characteristics of their liabilities and are less prone to price fluctuations. To conclude, in finding the right balance, Solvency II has been a big step in the right direction. Of course, we are still in its early years and Solvency II is not yet perfect. But we know also that Solvency II gives us opportunities in finding this balance. ●

Sébastien Raspiller

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Lifting the barriers to investments to achieve our common goals for Europe

Over the past years, we have reached a global consensus on the importance of long-term investment for our economy. Indeed, long-term financing in equity is necessary to innovate and develop technologies that will ensure the future growth of Europe. The European Central Bank recently concluded in this regard that equity funding is more appropriate than bank lending to support new technologies, and underlined that this is all the more the case for innovation related to green technologies, since these kind of development are intangible and firm specific, several characteristics which could discourage banks to intervene. Moreover, the current economic context calls for a breakthrough regarding the financing of our economy, which will be key for the recovery in the aftermath of the Covid-19 crisis.

On this basis, the European Commission and the co-legislators decided to launch the Capital Market Union and the Green ▶

▶ Deal, which encompass the long-term investment issues through the deepening and efficiency of European markets and the financing of the transition to a sustainable economy. However, these initiatives alone will not succeed if we do not lift the existing barriers to long-term investments. In this regard, the shortening of the time horizon of our European prudential and regulatory framework over the last years is preventing our financial undertakings from playing their natural role in the economy.

This is especially the case for the insurance sector's prudential framework, Solvency II. By focusing on short term risks, neglecting the capacity of undertakings to hold their assets in a long-term perspective, it hinders the investment capacity of these entities, although they are long-term investors by nature. Indeed, their business model relies on the inversion of the production cycle – they collect premium first and pay potential claims later – which allow them to invest for the long run, in front of life and non-life contracts. Besides the financing of the economy, long-term investors are stabilizers for the financial system as a whole: they act as a counter-cyclical force, with the ability not to sell in times of crisis. This key role in the economy, which is also the very purpose of our prudential regulations at the EU level, also has to be recognized and the current crisis illustrates this need for our economy.

Against this backdrop, following the recommendation stemming from the Next CMU report, the 2020 review of Solvency II should be the opportunity to better take into account the very nature of long-term investment. This means that the specificities of equities which are not to be sold, or at least which could be kept in difficult times, need to be recognized in the prudential framework. The long term equity investments module introduced in the 2018 review of the delegated acts is a step in the right direction in this regards.

Beyond, we also need to encourage the use of long-term products by consumers which intend to invest for the long-run. This is for instance what France did last year with the creation of a single and simple pension product for both insurers and asset managers. Such products could also, in combination with the necessary adaptation of our European regulations, foster long-term investments in our economy. ●