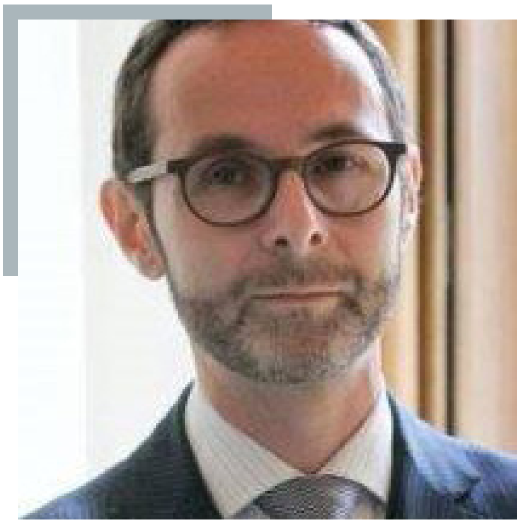

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Lighter capital requirements would allow European insurers to provide capital to the economy

European insurance regulation is not primarily designed to nurture the role these institutional investors can play in financing the European economy. The primary objective of regulation weighing on European insurers is to protect policyholders, from a twin prudential and consumer perspective. The detrimental effect of this regulation on investment capacity is recognized, but as a side-effect.

Furthermore, whenever a thought is given to the macroeconomic import of the insurance sector as a whole by EU institutions, it isn't primarily to address its investment capacity, thereby counterbalancing the aforementioned detrimental effects of microprudential regulation, but once again rather to address the risk the sector as a whole might pose to the economy by adding a further layer of so-called systemic regulation, thereby aggravating the investment disincentives already built in Solvency 2.

There wasn't anything foreordained in the unfavorable treatment of equity investments in microprudential regulation. When taking into account the time horizon of insurers as going concerns, the schedule of their cash flows and the structure of their liabilities, it is clear that a balanced portfolio comprising a sizable portion of well diversified equity investments is a better match than the current mix of their assets, which is massively overweight in fixed income. However, once the decision has been made instead to devise capital requirements on the basis of a mistaken one-year horizon, there is no escaping the fact that equity values can drop a lot in an accounting year, and thus to require a larger amount of capital for investing in equity rather than in debt instruments, notwithstanding their higher correlation and their lower rate of return.

It is unfortunately likely that the revision of Solvency 2 will go even further in turning insurers away from equity instruments. The sharpness of the drop of the interest curve in the recent years well below zero percent and the manifest flaws in the design of the standard formula has brought EIOPA to promote a large increase in the capital charge for fixed income instruments. A cursory view would welcome a reduction in the gap between regulatory capital requirements for equity and debt instruments; it would seem to reduce the disincentive to invest in equity. A plurality of governments sought for this reason to reduce the regulatory gap between instruments in the revision of the delegated Act by lowering the capital charge for some equities. However, this approach is mistaken and will not bring about the desired outcome. What counts, first and foremost, is the absolute level of solvency ratios. **A set of capital charges reducing the overall solvency ratios of the insurance sector will bring insurers to reduce their investment in equities**, even if the specific capital requirement in equity is lowered and the capital requirement for fixed income instruments is increased.

The French government has given much thought to the investment role of insurers for years and seeks to address it in part by creating a sizable pot of hybrid instruments. French insurers would invest in diversified funds of hybrid loans extended to French SMEs; these funds would benefit from a first loss guarantee from the French government, so as to apportion the risk between the issuer, the underwriter, the investor and the taxpayer. Depending on the quality of the underlying credits, the interest rate charged, the attachment point of the public guarantee and the diversification of the funds, these funds might help the national economy while providing a satisfactory risk-return profile to their institutional investors or to the life policyholders as ultimate beneficiaries. However, the regulatory treatment is yet to be known, and the misalignment of interest between originators, which may own other exposures in the capital structure, and investors makes the structure a complex proposition. Although large in absolute terms, the overall pot of hybrid loans would be around 1 percent of life insurance policyholders funds. Hence, reducing overall capital solvency requirements remains key for unlocking the investment capacity of the European insurance sector.