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How Solvency II could potentially not help the growth of the European economy

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Session Structure

Premise

Insurers are natural candidates in fulfilling the role of long-term investors for growth in the European economy. There is no reason – given sensible outcomes on the rules governing their business – why such a situation should not be permitted to flourish.

Principal themes

- Insurers as the natural providers of long-term investment
- Solvency II and the treatment of long-term insurance business
- European considerations of insurers' business and related investment behaviour
- Conclusions

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The Importance of Insurers as Investors

- Insurers are the biggest non-bank investors in Europe, with assets under management of over €7.7 trillion (at 31December 2011)
- 64% of these assets are held in government or highly-rated corporate bonds (see next slide).
- Long-term funding is required by private institutions and public bodies in order to promote growth on a micro and macro level.
- Traditional sources of investment (e.g. bank lending) have decreased from pre-crisis levels.
- Investing in long-dated assets in order to meet the liabilities arising from long-term insurance business means that insurers are well suited to playing a role in filling this funding gap.

Insurers CAN help the growth of the European economy.

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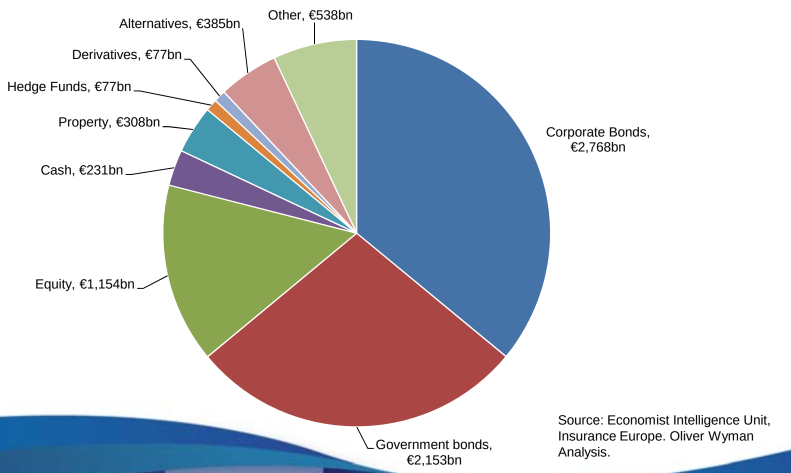
European Insurers' Asset Allocation



Source: Economist Intelligence Unit, Insurance Europe. Oliver Wyman Analysis.

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The Investment Decision

- Inevitably, a large number of factors will determine how – and in which asset classes – insurers invest the premium income from the liabilities that they have taken on. Considerations will include, among others:
  - Regulatory requirements;
  - Taxation environment;
  - Accounting treatment;
  - Prevailing macroeconomic conditions; and
  - Risk/Return of available assets.

Crucially, however, it is the liability-led nature of life insurers' long-term business that provides the driving force behind the investment decision.

- Assets will be chosen with duration, yield and liquidity properties that match those of their liability payments.

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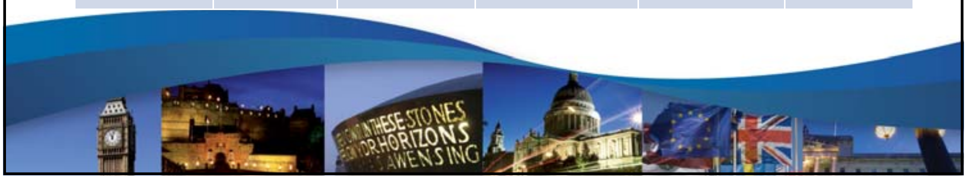
Typical Long-term Insurance Products

Product category (defined by EIOPA)	Liabilities at end 2011 (€bn)[EIOPA Statistical Annex Insurance 2011]	Duration of liabilities/ assets	Required liquidity	Target returns/ guarantees	Typical investment strategy
Non-life insurance (e.g. motor, household, catastrophe)	890	Typically 1-5 years	Medium (i.e. policyholder can lapse but no surrender value)	Typically not return promises so no return constraints	Short-term, liquid
Life insurance where insurer takes investment risk (e.g. annuities)	2,820	Typically > 8 years	Low (i.e. policyholder either: (i) cannot lapse; or (ii) lapses and surrenders carry a penalty)	Investment guarantees often built into products	Hold-to-maturity, yield selected to meet any guarantees
Life insurance where policyholder takes investment risk (e.g. unit-linked)	1,670	Typically 5-8 years	High (i.e. policyholder has option to surrender and policy value is paid at this point)	Target benchmark fund returns	Flexible, total return orientated



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Long-term Insurance and Solvency II

- In Solvency II, the treatment of long-term insurance business has been the subject of extensive discussion between Member States and policymakers.
- Long-term life insurance liabilities exist in different forms across the EU, with the products available to consumers in each jurisdiction exhibiting idiosyncratic features.
- Solvency II is a regulatory regime based on market consistency, which aims to more accurately reflect the value of insurance business on both the asset and liability side of a firm's balance sheet.

In certain cases, there is a risk of 'artificial volatility' in insurers' own funds being created that would not reflect the economic reality of long-term insurance business.

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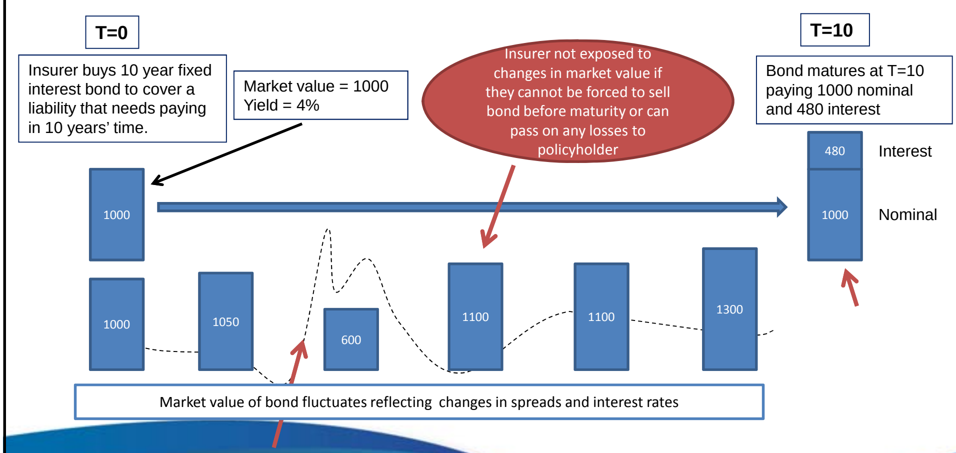
An Example



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Long-term Insurance and Omnibus II

- The treatment of long-term insurance business and how to reduce the effects of artificial volatility have dominated trialogue discussions on the Omnibus II Directive (Solvency II's amending directive).
- In September 2012, discussions on the Directive came to the conclusion that more data was required before agreement on the package of measures relating to long-term guarantees.
- The package of measures is necessary due to the different features of national markets – a single solution is not seen as a plausible outcome.
- As a result, the European Commission launched an impact assessment in order to test the likely effects on the insurance industry of a number of different drafting options in the final Solvency II rules.

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Long-term Guarantees Impact Assessment

- The impact assessment tested different scenarios related to the three principal measures contained within the long-term guarantees package:
  - Matching Adjustment
  - Counter-cyclical Premium
  - Extrapolation Methodology
- The data gathering phase of the impact assessment has now concluded and will be the subject of reports from both EIOPA and the Commission (expected in June and July, respectively).
- The results should allow for more informed debate in the trialogue meetings, with the aim being for Omnibus II to be concluded by the end of 2013.

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The Regulatory/Policy Balance

"As part of a broader policy response [to the financial crisis], the detailed calibration of the new regulatory and supervisory framework must effectively enable and incentivise the financial sector to support the real economy […] without jeopardising financial stability."

'Long-term financing of the European Economy', European Commission Green Paper (March 2013)

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Institutional Considerations

- The European Commission, as well as other institutions, clearly appreciates the importance of insurers as investors and the need to strike the correct balance between incentivising this behaviour and setting appropriate regulations. To this end, the Commission has previously:
  - Formed a long-term guarantees working group; and
  - Commissioned the long-term guarantees impact assessment.

- It is not just valuations of liabilities, however, which is why the Commission is also considering the calibrations pertaining to (and, therefore, the level of capital to be held against) various asset classes under Solvency II:
  - Letter to EIOPA in September 2012 asking for a review of the capital charges applicable to certain classes of assets; and
  - Production of a green paper in March 2013 on long-term financing of the European economy.

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EIOPA Calibration Paper

- Discussion paper on '*Standard Formula Design and Calibration for Certain Long-term Investments*' published in April 2013.
- Resulted from the Commission's request to investigate the capital charges applicable to (at least) the following asset classes:
  - Infrastructure financing (through project bonds, debt and equity);
  - SME funding (through debt and equity);
  - Socially responsible investments and social business financing (through debt and equity); and
  - Securitisation of debt (serving the purposes of the previous three categories).
- EIOPA is yet to come to a conclusion/undertake further work in relation to SME securitisation and infrastructure project bonds. The regulator does not propose any changes to the other calibrations.

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Commission Green Paper

- Released in March 2013: '*Long-term Financing of the European Economy*'.
- Instigated as a result of *"Europe's pressing challenge to put the EU back on the path of smart, sustainable and inclusive growth…"*
- A concise paper that focuses on five main areas:
  - The supply of long-term financing and characteristics of long-term investment;
  - The capacity of financial institutions to channel long-term finance;
  - The efficiency and effectiveness of financial markets to offer long-term financing instruments;
  - Cross-cutting factors enabling long-term saving and financing; and
  - The ease of SMEs to access bank and non-bank financing.

Significantly, it demonstrates an increased political will to create the conditions for long-term investment by insurers; recognising the valuable role that they have to play in getting the European economy back on track.

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Conclusions

- The nature of insurers' long-term liabilities makes them a natural fit for investments in assets of long-duration; as the largest non-bank investors in Europe, funding potential is large.
- Insurers' asset allocation tends to be aligned with precisely the sort of financial instruments preferred by policymakers as the foundation for fresh economic growth in Europe.
- In Solvency II, two considerations for insurers when deciding in which assets to invest are:
    - The methodology for valuation of liabilities; and
    - The capital charges applied to investments in various asset classes.
- Both of the previous bullets are currently under consideration by European institutions – the need to find pragmatic solutions is understood.

There is a real opportunity to create the necessary conditions for insurers to help achieve European growth.

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Questions?