The Solvency II review – A unique opportunity to lift the prudential barriers to long-term investments by insurers

Submitted by France, Luxembourg and the Netherlands

After years of negotiations, the European prudential regime for insurance, Solvency II, entered into force on January 1st, 2016. This framework provides for a strong and sound insurance system, through capital and governance requirements, an enhanced risk management, and improved reporting to supervisory authorities and consumers. This one-of-a-kind example of harmonisation in the world has strengthened the whole financial markets in Europe, as proven by the resilience of insurance companies at the height of the Covid-19 crisis.

However, since its creation, the European prudential framework raises concerns regarding its volatility, as its quantitative requirements are focused on short term risks. The long-term guarantee measures were introduced within the Omnibus II directive to correct this bias. They are very useful for the functioning of our insurance sector, in particular in times of crisis, but they do not sufficiently address the issue of long-term investments by insurers.

Indeed, the current state of Solvency II neglects the capacity of insurance undertakings to hold their assets for the long-term. By doing so, it hinders the investment capacities of these entities, despite them being long-term investors by nature. The business model of insurers relies on the inversion of the production cycle – they collect premium first and pay possible claims later – which allows them to invest for the long run, either in front of life and non-life contracts.

Insurance companies' investments in equities are clearly below their potential, hindering the benefits of sectoral regulations to financial stability as a whole and limiting their impact on the financing of the European economy. Insurance companies are underinvested in equities. This is all the more serious that they are, on the contrary, very exposed to fixed income products despite the current economical context. The Next CMU report which was presented in October 2019 concurs with this observation, underlining the unintended effect of Solvency II that is resulting in making equities the adjustment factor during financial crisis as emphasized during the the Covid-19 crisis, thus encouraging pro-cyclical behaviour by entities that are supposed to act counter-cyclical[1]. In the same vein, the Institut Louis Bachelier recently concluded that, on the basis of portfolio optimization with or without the constraint of Solvency II, the prudential framework for insurance was leading to an important decrease – more than ten points, depending on the liabilities constraints, of equity investments compared to an optimal allocation.

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The 2020 review of Solvency II is a unique opportunity to better take into account the characteristics of long-term investments by insurers. 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 Solvency II framework. Indeed, these equities should not be treated as if the insurers would be compelled to realize losses in the short run, since these losses would

[1] *"Savings and sustainable investment union"*, The Next CMU High-Level Group, report to ministers and presented to the Finnish presidency, October 2019.

not be underwent in practice. Such provisions would not go back on the fundamentals of Solvency II, but would adapt the framework to the economic reality of insurers. We tried to tackle this issue by amending the market risk module, which is related to the risk of depreciation of assets. The idea was simple: if an insurer can prove that all or part of its equities can be hold for the long-term, even in stressed situation, its solvency requirements are set at a lower level, reflecting the fact that the one-year horizon loss will never be underwent.

The long term equity investments module introduced in the 2018 review of the delegated acts was created on these basis and was a step in the right direction. Indeed, this new asset class acknowledges the need to improve the prudential treatment of long-term investments in equities by insurers. However, there is still a confusion between the necessary assessment of the ability to hold equity investments for the long-term, which is enough to justify an adaptation of their prudential treatment, and the obligation to keep them in practice, a constraint that prevents insurers to fulfil properly their task as investors and has no conceptual rationale.

We need to improve this long term equity investment module on the basis of EIOPA's proposal, which contains some interesting reflections. As stated above, the main difficulty of this mechanism is, beyond its complexity, the constraint it imposes on the holding period of equities – at least five years on average. The insurers are thus compelled not only to assess their ability to hold equity for the long-term, which would be the right measure of a lower risk justifying an adaptation of the prudential requirements, but also to manage them in a way that may not be optimal neither prudent. We welcome that EIOPA proposes to remove this constraint (paragraph 1(e), article 171a of the delegated regulation).

In the same vein, the prohibition to use the assigned portfolio of assets to cover losses arising from other activities of the undertaking (paragraph 1(c) of article 171a) is very difficult to implement on the ground since insurance undertakings, as well as supervisors and public authorities, struggle to understand its operational consequences. We welcome that EIOPA proposes to delete this sentence, as well as to modify the criteria 1(b), even though we would recommend to go further, removing the whole obligation to manage this portfolio separately. Indeed, this constraint appears difficult to understand and bring no added value regarding the level of prudence of the long-term equity investments asset class.

However, some new eligibility criteria proposed by EIOPA do not seem conceptually justified and would need to be modified. In particular, the new conditions of paragraph 1(g), involving a very simplistic and one-size-fits-all approach of illiquidity of both life and non-life liabilities, would result in unnecessary complexity while not being sufficient to fully encompass the characteristics which allow insurers to invest for the long-term.

Regarding life insurance, EIOPA proposes to assess the illiquidity of the liabilities according to the same method as for the calculation of the volatility adjustment application ratio 5 (*Ar5*). Such an approach is not tailored to evaluate the ability of an insurer to hold its equities, since the liquidity or illiquidity of the liabilities is not the only parameter to be taken into account when proving that an insurer can avoid any fire sales within its equity portfolio. Likewise, the proposed criteria regarding the Macaulay duration of the liabilities is also not relevant for the purpose of this long-term equity investments module.

As for non-life insurance, insurers would have to prove that they have a sufficient liquidity buffer in order to benefit for the long-term equity investments module. Although this approach is conceptually close of the liquidity test we propose below, its implementation on the ground would be far less easy since the proposed methodology, which is strongly inspired from the banking framework, does not take into account the characteristics of the insurer's balance sheet as a whole.

These new provisions could be replaced by a liquidity test, allowing to assess properly insurers' capacity to hold their equities (*cf.* annex). Indeed, a liquidity test would be the right instrument to prove that an insurer is able to avoid forced sales on some – if not all – of its equities, and thus should not be subject to the regular prudential treatment of equities.

In a forward-looking liquidity test, the insurer should substantiate that in the coming 5 years the liquidity position will not trigger the sale of equity, even in the case that the scenarios used for calculating the SCR, and that would result in cash outflows, would become reality. This test could rely on the proof that, in such stressed conditions, on an ongoing basis, and for every year of the projection, asset cash flows cover liabilities cash flows. This test could include the whole balance sheet of the insurer, including own funds.

Furthermore, it would be useful to simplify the framework by introducing a single correlation matrix between the different market risk modules. Currently, this correlation matrix, as defined in Article 164 of the Delegated Regulation, involves a parameter "A", which is equal to 0 when the insurer is subject to a risk of an increase in the interest rates curve, and 0.5 in the case of downside risk. Thus, two different matrices coexist, which creates an artificial complexity hampering the risk management and control by the insurer. This parameter A could be set to 0 in any case, all the more that the current long-lasting economic environment has shown that the decrease of interest rates is correlated with an increase of the value of equities (the correlation is thus negative, and not positive).

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The coming review of Solvency II will be an opportunity that should not be missed to acknowledge the specificities of long-term investments. This is a necessary condition for the economic growth of the Union, development of new technologies and climate transition, as well as to the financial stability as a whole.

Proposal for an amendment of article 171a of the delegated regulation on the basis of the EIOPA's proposal

1. For the purpose of this Regulation, a sub-set of equity investments may be treated as long-term equity investments if the insurance or reinsurance undertaking demonstrates, to the satisfaction of the supervisory authority, that all of the following conditions are met:

a) the sub-set of equity investments is clearly identified;

b) the sub-set of equity investment is included within a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, ***including own funds,*** and the undertaking maintains that assignment ;

c) the assigned portfolio of assets referred to in point (b) are identified ~~and managed separately from the other activities of the undertaking~~;

d) [Replaced by new number (2)]

e) a policy for long-term investment management is set up for each long-term equity portfolio and reflects undertaking's commitment to hold the global exposure to equity in the sub-set of equity investment for a period that exceeds 5 years on average. The AMSB of the undertaking has signed off these investment management policies and these policies are frequently reviewed against the actual management of the portfolios;

f) the sub-set of equity investments consists only of equities that are listed in the EEA or of unlisted equities of companies that have their head offices in countries that are members of the EEA;

g) ***the insurance or reinsurance undertaking comply with a positive liquidity test, as defined in paragraph 2, of its whole balance sheet at solo level, relying on forward-looking scenarios with a time horizon of five years. This liquidity test provides evidence that the insurance or reinsurance undertaking is able to hold on an ongoing basis the equity portfolio in the long term because of the structure of its balance sheet. The liquidity test should be performed without selling equity assets at loss in the portfolio;***

~~where undertakings can demonstrate that either~~

~~i. particular homogeneous risk groups of the life insurance and reinsurance liabilities belongs to categories I or II as defined for the purpose of the calculation of the VA and the Macaulay duration of the liabilities in this HRG exceeds 10 years or~~

~~ii. a sufficient liquidity buffer is in place for the portfolio of non-life insurance and reinsurance liabilities and the assigned portfolio of assets;~~

h) the risk management, asset-liability management and investment policies of the insurance or reinsurance undertaking reflects the undertaking's intention to hold the sub-set of equity investments for a period that is compatible with the requirement of point (e) and its ability to meet the requirement of point (g) ;

Those elements are reported in the ORSA of the undertakings.

i) the sub-set of equity investments shall be properly diversified in such a way as to avoid excessive reliance on any particular issuer or group of undertakings ***with the same risk profile*** ~~and excessive accumulation of risk in the portfolio as a whole.~~ ;

~~2. The proportion of equity backing life technical provisions that is assigned to the long term equity investment category does not exceed the proportion of life technical provisions compliant with the criteria specified in paragraph 1 on the total life technical provisions of the insurance or reinsurance undertaking.~~

2. The liquidity test relies on the demonstration that, every year of the 5-year time horizon, in a deterministic stressed scenario, the difference between asset cash flows and liability cash flows is always positive. To this end:

(a) the asset cash flows:
- ***include cash and cash financial instruments income cash flows;***
- ***include recurrent revenues rising from assets (e.g. coupons, property rents, dividends);***
- ***include income cash flows rising from bonds sales and redemptions;***
- ***include outcome cash flows coming from debt items on the asset side (e.g. existing repurchase agreements);***
- ***exclude income cash flows rising from the reinvestment of the previous cash flows.***

The cash flows of the long term equity submodule are limited to dividends.

(b) the liability cash flows include:
- ***outcome cash flows rising from claims;***
- ***income cash flows rising from future premiums of in force contracts, including renewals for the next 5 years;***
- ***outcome cash flows rising from expenses and taxes;***
- ***outcome cash flows rising from insurance or reinsurance undertaking funding (e.g. distributed dividends, debt interest and redemption).***

(c) for the definition of the stressed conditions, the insurance or reinsurance undertaking can choose between the two following methods:

(i) the shocks within the SCR are calculated in accordance with the standard formula, as referred to in article 105 of Directive 2009/138/EC, with the method used and the correlation matrix of the SCR. Based on the calculated SCR, the insurance or reinsurance undertaking determines the relative contribution of each sub risk to the SCR. The insurance or reinsurance undertaking aggregates all the diversified amounts of (i) the sub risks where a cash outflow results from the scenario and (ii) the stressed values of equities. When a risk sub-module is expected to result in a more than 50% cash outflow, it is assumed that the cash outflow is 100%;

(ii) for the purpose of simplification, the second method reflects all the risks of the standard formula, aggregated in one unique scenario according to the risk profile of the insurance or reinsurance undertaking, its SCR and Best Estimate calculations and correlation matrix as referred to in Annex IV of Directive 2009/138/EC. The

insurance or reinsurance undertaking applies a single 50% reduction factor to this calculation;

(d) within the operational risk module, the risk capital charge results in a cash outflow. The losses caused by the operational risk result in a cash outflow. The expected outflow of cash caused by margin calls of derivatives is based on the interest rate sub-module.

3. Where equities are held within collective investment undertakings or within alternative investment funds referred to in points (a) to (d) of Article 168(6), the conditions set out in paragraph 1 of this Article may be assessed at the level of the funds and not of the underlying assets held within those funds.

4. Insurance or reinsurance undertakings that treat a sub-set of equity investments as long-term equity investments in accordance with paragraph 1 shall not revert to an approach that does not include long-term equity investments. Where an insurance or reinsurance undertaking that treats a sub-set of equity investments as long-term equity investments is no longer able to comply with the conditions set out in paragraph 1, it shall immediately inform the supervisory authority and shall cease to apply Article 169(1)(b), (2)(b), (3)(b) and (4)(b) to any of its equity investments for a period of 36 months.

5. Participations shall be excluded from the sub-set of equity investments.