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Position Paper

Response to the European Commission consultation on the Capital Markets Union (CMU) mid-term review

Our reference:	PAC-17-060	Date:	17 March 2017
Referring to:	EC public consultation on the CMU mid-term review		
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Pages:	9	Transparency Register ID no.:	33213703459-54

General remarks

Insurance Europe welcomes the opportunity to provide input to the Capital Markets Union (CMU) mid-term review.

To make a real difference and deliver on the objectives of the CMU, the Commission needs to take bolder and quicker action to tackle a number of outstanding investment concerns and barriers. The industry welcomes the work launched so far by the EC in the areas of infrastructure and STS securitisations, however, these assets represent a small percentage of insurers' asset portfolios. While a prudential treatment better aligned to true risks creates scope for additional investments, the EC should not focus solely on those assets and ignore the other 98% of investments, most of which are long-term and crucial to growth and stability in Europe. Further work on these is also needed.

Solvency II remains a key regulatory challenge for insurers, as it wrongly assumes that insurers act like traders and are fully exposed to market volatility, thus forcing them to hold unnecessarily high capital. The Commission should address a set of straightforward and key questions, including:

i) To what extent does Solvency II recognise that insurers are often not exposed to short-term volatility in market movements?

ii) Is the current Solvency II assumption that insurers would be forced to sell their entire portfolio at a huge loss in a time of stress reasonable and backed by evidence? Answering such questions would make perfect sense in the context of assessing the barriers to and risks facing long-term investment in Europe.

In addition to addressing Solvency II prudential barriers, EC actions should support the development of suitable assets in which to invest, such as infrastructure and private placements. In the area of infrastructure, significant improvements have been noted in recent years on the supply side. However, concerns remain on issues such as the risk of public support crowding out private investment. This needs to be addressed by more focus on additionality in the use of public money. Similarly, private placements markets have been developing significantly in a number of member states. The Commission should identify best practices in this area and promote them more widely across the EU.

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In the area of consumer protection, Insurance Europe urges the Commission to address the negative consequences of information overload and duplication for consumers and the mandatory default paper requirements for disclosures. Identifying a clear path and timeline to address these problems would be a decisive step towards making insurance regulation digital-friendly and future-proof.

Lastly, Insurance Europe acknowledges that a pan-European personal pension product (PEPP) may help meet CMU objectives, provided it includes key product features that have proven instrumental in providing European citizens with tailored retirement solutions (eg a long-term horizon, a decumulation phase).

Insurance Europe looks forward to continuing its engagement with the EC to create a strong CMU and help deliver this Commission's agenda.

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ANNEX - DETAILED ANSWERS TO THE EC CONSULTATION ON THE CMU MID-TERM REVIEW

1. Financing for innovation, start-ups and non-listed companies

Are there additional actions that can contribute to fostering the financing for innovation, start-ups and non-listed companies?

- X Yes
- No
- Don't know / no opinion / not relevant

(If yes) Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation. ***(5 000 characters max.)***

Swift action by the EC is needed to support investment by European investors, such as insurers, in growth-generating assets. The aim should be to remove current regulatory barriers and disincentives and allow insurers to achieve optimal portfolio allocations by investing in suitable assets. This would also ensure that European financial markets are equally accessible to both foreign and domestic institutional investors. Currently this is not the case; in recent years, foreign investment in European equity has significantly surpassed domestic investment[1].

More action is needed on the Solvency II treatment of insurers' investments.

Insurers have an interest in and an ability to invest in a wide range of assets, including equity (listed and non-listed, public and private), bonds (corporate, SME loans, private placements), infrastructure, real estate (including mortgage loans and residential housing), to achieve portfolio diversification and access superior yields. The EC's prioritisation of specific asset segments is understood, but it should not limit its focus to only a few percentage points of insurers' total assets.

In recent years, the anticipation of Solvency II has been one of the factors impacting insurers' asset allocations. For example, the share of equity in portfolios has shrunk significantly — remaining at around €800bn despite total assets almost doubling from €5.8tn to €9.6tn between 2004 and 2014.

The design and calibration of the Solvency II framework assume that insurers act like traders and are exposed to short-term risks, even where there is no realistic risk of early or forced sales, and even in cases where the investments are illiquid and have no market price. This incorrect measurement of risk leads to unnecessarily high capital requirements and disincentivises investment.

Insurance Europe strongly encourages the EC to investigate the current Solvency II treatment of debt-like assets (eg SME loans, private placements), in line with its work on infrastructure, where the focus has been on measuring insurers' true risk exposure. Specifically, the 2015 EC letter to EIOPA[2] included an explicit request to investigate exposure to counterparty default risk and it was this that led to better reflection of the real risks and more appropriate calibration of infrastructure project finance in Solvency II.

Similarly, the current treatment of equity fails to recognise the very significant difference between trading equity risk and exposure to long-term equity risk. One way to address this would be to recalibrate capital charges on equity to reflect lower risks when long-term equity investment strategies match long-term liabilities.

[1] See 2013 report "Who own the European economy?"
[2] https://eiopa.europa.eu/Publications/Letters/150204%20EIOPA%20call%20for%20advice%20infrastructure.pdf

Several key questions should be investigated and addressed by the EC, including:

- Is there a difference between measuring exposure to long-term equity/default risks and exposure to short-term trading equity/market risks?
- Does the accumulation of dividends impact equity risk exposure differently over the long-term vs one year?
- Does the ability of insurers to avoid forced sales change their actual risk exposure? Is the current Solvency II assumption that insurers would be forced to sell their entire portfolio at a huge loss in a time of stress reasonable and backed by evidence?
- Given that capital requirements influence investment decisions, to what extent is the Solvency II framework able to recognise that insurers are often not exposed to short-term volatility of market movements?

Insurance Europe recognises that the current Solvency II methods were, in some cases, chosen because of fear of creating incentives for insurers to make inappropriate investments and engage in excessive risk-taking. However, before rejecting any changes on these grounds, policymakers should provide evidence that:

- This was a significant issue before Solvency II application, when there were no risk-based requirements
- The combination of Solvency II comprehensive pillars (capital, governance, and reporting) are not sufficient to address such concerns
- There are no alternative methods to address these concerns

The above-mentioned areas should be investigated as a matter of urgency as part of the ongoing 2018 Solvency II review process. Swift action to address barriers should be envisaged to support funding of the European economy – as was the case in banking, where consideration of the SME supporting factor was aimed at maintaining banks' lending ability.

It should be stressed that the industry supports the risk-based nature of Solvency II and does not believe that it should be used to provide *incentives* to long-term investment. On the contrary, investigations should focus on identifying and removing *disincentives*, by calibrating capital charges based on the actual risks faced. Solvency II is — and should remain — a risk-based framework, but more work is needed to ensure that the risks are correctly identified and measured.

2. Making it easier for companies to enter and raise capital on public markets

Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets?

- Yes
- No
- X Don't know / no opinion / not relevant

Insurance Europe encourages the Commission to investigate the extent to which issuers prefer private placements may be caused by the excessive cost of listing on regulated markets.

(If yes) Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation. ***(5 000 characters max.)***

3. Investing for long-term, infrastructure and sustainable investment

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Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment?

- X Yes
- No
- Don't know / no opinion / not relevant

(If yes) Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation. ***(5 000 characters max.)***

Insurance Europe supports the EC's work to reduce barriers to investing in infrastructure and sustainable finance. However, these assets account for less than 2% of insurers' investments. While prudential treatment better aligned to true risks creates scope for additional investments, the EC should not focus solely on these assets and ignore the other 98% of investments, most of which is long-term and crucial to growth and stability in Europe. Further improvements on these is also needed, and concrete suggestions for addressing current barriers have been provided in the response to question 1.

In the specific area of infrastructure, the industry welcomed the EC's 2015 work leading to the recalibration of project finance in Solvency II. Unfortunately, this work did not cover infrastructure corporates, which are an important part of the infrastructure universe. Insurance Europe supports the extension of the capital treatment for project finance to qualifying infrastructure corporates with similar risk profiles.

Equally importantly, the lack of an appropriate supply of suitable infrastructure assets remains a key concern. A recent survey by Insurance Europe revealed positive developments in the infrastructure market in recent years, but also indicated several challenges that should be addressed.

Key survey conclusions include:

- Interest by insurance companies in infrastructure has grown over recent years and new players have entered the market. A number of large European insurance companies have made public commitments to each allocate several billion euros to infrastructure in the coming years and to increase their exposure from less than 1% to more than 5% of their portfolios. However, reaching such objectives can only happen if suitable projects are in place.
- The pipeline of infrastructure projects has improved, but remains weak and there is a clear perception that insurers still lack projects in which to invest.
- There is lack of visibility of upcoming projects, which makes it difficult for investors to plan.
- Political risk remains a key challenge across all markets; there is uncertainty about contract fulfilment and pricing.
- EFSI and other types of MDB/NDB support have benefited many European projects, both infrastructure and SMEs. However, in some markets, the use of EFSI or similar types of public support was perceived as counter-productive and a range of examples of "crowding out" have emerged. EFSI therefore needs to focus more on the concept of additionality.
- There is increased interest in green finance, however there is a significant gap in supply. It should be noted that infrastructure investments are not selected based on their "green" characteristics but based on firms' usual economic analysis; if a project does not make economic sense, it will not gain support. There is also increasing concern about "green washing" (ie projects labelled as green that are not really green).

In addition to the concerns above and the actions outlined in response to question 1, future work by the EC should consider:

- Identification of best practices and successful experiences in member states regarding ways in which the insurance sector, sometimes in partnership with other sectors, contributes to the financing of the

real economy. For example, European private placement markets have started to play an increasingly important role in funding SMEs. Insurance Europe welcomes the recent EC study to identify both regulatory/market barriers and good practices in the development of private placement markets. Bold action is needed in both areas.

- Strong regulatory requirements on additionality and strong governance rules, to ensure that EFSI/public support does not crowd out private investors.
- Ways to encourage the development of credit rating assessments and, concretely, alternatives to external credit assessment institutions (ECAIs). The availability of credit rating-like information is very important for insurers when making investment decisions, particularly in cases where such information is not available from ECAIs (eg private placements, loans to SMEs, etc). Alternatives should include internal credit risk assessment models, as well as other private or public models, subject to appropriate supervisory controls.
- The extent to which current developments in financial reporting are appropriately designed and reflective of insurers' long-term business model. Insurance Europe encourages the Commission to work closely with the International Accounting Standards Board (IASB) in the final stage of the insurance contracts project (IFRS 17) and to support an approach that achieves a faithful presentation of insurance business in insurers' financial statements.
- An investigation into the fall in liquidity for corporate bonds, and the link to central bank purchasing activities. Insurers have been facing both significant challenges in accessing primary markets and higher costs of trading in thin secondary markets.

4. Fostering retail investment and innovation

Are there additional actions that can contribute to fostering retail investment?

- X Yes
- No
- Don't know / no opinion / not relevant

(If yes) Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation. ***(5 000 characters max.)***

Transparency and disclosure

Product disclosure is key for consumer and retail investor confidence and to help them to make informed choices. As part of the call for evidence, Insurance Europe pointed to the negative consequences for consumers of information overload and duplication stemming from the cumulative application of the Solvency II Directive, the PRIIPs Regulation and the Insurance Distribution Directive (IDD). Regrettably, these pieces of insurance legislation, have been developed and adopted by the European regulators in silos. The introduction of these rules on top of existing legislation will dramatically increase the amount of pre-contractual information that insurers will be required to provide to consumers. As a result, consumers risk being overloaded with information, confusing them and distracting them from important information, such as the policy coverage and exclusions.

It is essential to allow time for legislation to be implemented and for its impacts to be comprehensively assessed before considering any new rules in the same field. This would be in line with the European Parliament report on stocktaking and challenges of EU financial services regulation, in which MEPs call for a thorough assessment of the "overall impact" of EU legislation, including "the effectiveness and appropriateness of the framework for retail investors, institutional investors and consumers and customers". For instance, Insurance Europe believes that the EC request to the ESAs to work on the transparency of fees and net performance of long-term retail and pension products, as well as the launch of a study on the distribution

systems of retail investment products across the EU in the framework of the CMU mid-term review, should not have been issued before the implementation of the rules that are still under discussion for PRIIPs and the IDD.

Insurance Europe also underlined the problem of having to make these disclosures on paper as a default requirement, which is a significant barrier to digitalisation. The follow-up action plan to the call for evidence is very disappointing in this regard and does not meet the CMU objectives. Identifying a clear path and timeline to address these problems would be a decisive step towards making insurance regulation consumer- and digital-friendly, as well as future-proof.

Personal pensions

Personal pensions are an important driver of long-term growth, particularly when private pension products aim to provide retirement income, which usually translates into features that allow the allocation of funds to long-term investments. Long-term investments can only be made on the basis of long-term liabilities. Insurance Europe therefore welcomes the EC's endeavour to link its EU personal pension product (PEPP) initiative to the CMU.

This link was, however, not properly reflected in the recent consultation on personal pensions, where the Commission did not give due consideration to the long-term features of these products. Unless this is addressed, the Commission's investigations into personal pensions will not bring the expected results in relation to the CMU.

For the PEPP to be appropriate to the Commission's CMU objectives, the following are required:

- The PEPP needs to allow providers to generate long-term liabilities, so consumers have to be incentivised to save for a long period, ideally until retirement. Minimum investment periods should therefore be included in the PEPP framework. PEPP providers should be allowed to design the number and length of minimum holding periods embedded in their products, as this is essentially a business decision.
- PEPP providers should be subject to appropriate prudential treatment. The "same risks, same rules" principle should apply to ensure a level-playing field between all providers. For PEPPs with minimum return guarantees and/or biometric risk coverage, the applicable framework should be Solvency II. However, providers' ability to manage market volatility in the long-term should be taken into account.
- The PEPP needs to include the option for the consumer to ask for additional biometric risk coverage (eg mortality, disability), either during the accumulation or the decumulation phase (taking into account national practices).
- Since pension products are generally defined by their objective to provide an income in retirement, the protection of longevity risk should be considered among the options offered to consumers, in line with national rules.
- The PEPP should include an appropriate level of security for policyholders.
- Despite taxation being a national competence, the EC needs to clarify what tax incentives the PEPP would enjoy, since these are key to stimulating people into saving for retirement,
- National practices and rules on decumulation and protection mechanisms, such as pay-outs and annuities, and survivor's/death benefits, should be considered in any discussion at EU level.

5. Strengthening banking capacity to support the wider economy

Are there additional actions that can contribute to strengthening banking capacity to support the wider economy?

- X Yes
- No
- Don't know / no opinion / not relevant

(If yes) Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation. ***(5 000 characters max.)***

In two key areas, covered bonds and securitisations, further work by the Commission could enhance banking capacity to support the wider economy and, as a consequence, enhance insurers' access to these assets.

With respect to covered bonds, Insurance Europe understands the efforts by the Commission to make these markets more efficient and welcomes the recognition that covered bonds are an important mechanism for channelling long-term financing and investment to the real economy. Insurers have, in recent years, operated as investors in covered bonds in many European countries and cross-border investment in covered bonds is already taking place to a significant extent, despite member state market specificities.

It is in the best interest of insurers as investors in covered bonds that any initiatives by the Commission do not disrupt these well-functioning markets. While the industry agrees that in some cases harmonisation could encourage and facilitate additional cross-border investment, insurers do not support the facilitation of such investment at the cost of losing important features of existing national regimes. Specifically, with regards to future work on covered bonds, the EC should:

- Ensure that any changes in the covered bonds framework are beneficial for covered bond investors and do not contradict their business model.
- Avoid interference with existing legal frameworks in member states related to insolvency law or data protection.
- Avoid interference with existing local mortgage markets, which in many cases have developed strong connections to the covered bonds market.
- Avoid a watering down of existing and strong covered bond regulations and quality standards. Given that "strong" regulations are often very different regulations, it is difficult to imagine a new framework that achieves a single outcome of comparable value.

With respect to securitisations, the new STS framework design should maintain banks' interest and ability to issue such products. This is directly relevant to and important for the insurance industry, which is already invested in these assets and has a clear interest in investing more in the future. Two key regulatory issues must be swiftly addressed:

- Finalisation and adoption of the STS regulation, followed by transposition into relevant sectorial regulations such as Solvency II. The STS regulation addresses some of the concerns that insurers had previously identified in Solvency II with respect to criteria for qualifying securitisations. For example, the Solvency II approach wrongly assumes that all junior tranches should be assigned to a basket of "low quality" (type 2) securitisations. This implicitly leads to significant cliff-edge effects in the capital requirement between senior and junior tranches of the same securitisation.
- Swift follow-up action on the recalibration of Solvency II capital requirements, which remain excessively conservative. As noted in the answer to question 1, the current calibrations assume full exposure to market and volatility risks, and therefore lead to much higher capital requirements than exposure to credit/default risk.

Insurance Europe looks forward to future opportunities to contribute to policy developments and actions in the areas of covered bonds and securitisations.

6. Facilitating cross-border investment

Are there additional actions that can contribute to facilitating cross-border investment?

- X Yes
- No
- Don’t know / no opinion / not relevant

(If yes) Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation. ***(5 000 characters max.)***

Insurance Europe notes that provisions around insolvency and enforcement laws, as well as withholding tax procedures, which are different between member states, are often quoted by insurers as a challenge to cross-border investment.

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