21 May 2012

Dear Minister of Finance,

The outcome of the Omnibus II trialogue discussions will determine the success of Solvency II, the new EU framework for prudential supervision. The stakes are high given the important role the insurance industry plays for its customers but also, with nearly €7,500bn of assets under management and €1,200bn of new premiums to invest annually, for the European Economy and its growth agenda.

A well designed Solvency II framework should provide a safe regulatory regime that captures the real risks for insurers. In particular, Solvency II must provide the right incentives for the provision of long-term investment, for economic growth and for long-term products for customers to plan their retirement. However, the industry's ability to take a long-term approach to investment that supports the long-term guaranteed products and pensions offered to customers, financial stability and economic growth, is currently at risk. A working group of the Bank of International Settlements, chaired by Peter Praet, member of the ECB's Executive Board, reached a similar conclusion[1]:

> "A related concern is whether life insurers and pension funds can maintain a long-term investor perspective. […] A partial retreat of institutional investors from the long-term and/or illiquid segment of the credit market could reduce the private and social benefits the sector generates through long-term investing, and the extent to which it mitigates the pro-cyclicality of the financial system."

In our view, the Omnibus II discussions do not recognise the significant unintended consequences Solvency II could have for consumers and the European Economy if the Omnibus II text and subsequent Level 2 measures are not worded appropriately.

The significant volatility in financial markets since 2008, stemming from significant movements in credit and government bond spreads whose consequences were not foreseen in the Solvency II Directive, has shown that the proposed Solvency II regime will introduce more volatility in the balance sheet and consequently in the own funds than originally envisaged. This will make insurance business appear far more volatile than it really is.

Insurers manage large diverse pools of liabilities and assets for the benefit of their customers. Our liabilities are generally long-term and have stable cash outflow profiles. Therefore, insurers are substantially able to match these long-term liability profiles with cash inflows of long-term investments and hold assets to maturity. By taking a long-term investment perspective, the insurance

[1] BIS (July 2011) "Fixed income strategies of insurance companies and pension funds"; report submitted by a Working Group established by the Committee on the Global Financial System.

industry not only supports the 'real economy' but also makes a significant contribution to financial stability as it is not a forced seller of assets in volatile markets.

Unforeseen and unintended consequences that would damage the environment for vital pension savings and long-term investments for millions of EU citizens and businesses must be avoided. Actions that address these issues and remove barriers to long-term investments, including for example corporate bonds, infrastructure and other long-term assets, will enable insurers to support national governments, particularly as they look to stimulate the real economy and address the challenges of the ageing population across Europe and increasing pensions savings gap. A 2011 report in the OECD Journal stressed the important role of institutional investors[2]:

> "So, in conclusion, infrastructure investment drives wider economic growth. Long-term institutional money is a great match for infrastructure assets and it can help bridge the infrastructure-funding gap […] And finally, we should seek in wider solvency regulation to facilitate, not disincentivise, a greater mobilisation of pension and insurance fund capital towards investment in infrastructure."

There are measures under discussion which, if implemented appropriately, can address this significant volatility issue but under current draft texts they will be applied in such a limited way that they will not work as proposed. These concepts were initially developed by a Working Group on Long-Term Guarantees set up by the European Commission in 2011 and comprise three key elements, each of which plays a crucial role:

- A **Matching Adjustment** (MA) to reflect an insurer's true risk position where the insurer manages its business to avoid exposure to volatility in movements of asset values caused by spreads. The real risk being the loss in the event of actual asset default, not the short-term movements in value while the asset is being held.
    - The current drafting of this concept by the European Parliament is far too restrictive, so in practice it would not work for most products across Europe.
    - The industry has worked jointly to develop a methodology fully reflecting the economics, ensuring the policyholder is protected to the very high Solvency II target levels, and recognising good risk management.
- A **Counter-Cyclical Premium** (CCP) which is a critical element of Solvency II would help insurers to cope with distressed market conditions and avoid counter-productive and pro-cyclical behaviour.
    - Insurers have been able to meet their obligations towards policyholders throughout the crisis, mainly because the nature of their liabilities allowed them to absorb short-term market volatility.

[2] Martin Stanley (2011) "Investing in Infrastructure: Getting the Conditions Right", OECD Journal: Financial Market Trends, Volume 2011 – Issue 1

- The excessive volatility in the market does not reflect the solvency position of insurance companies given the limited vulnerability (particularly in extraordinary markets) to such short-term volatility.
- It is very important that a consistently defined CCP is sufficiently predictable to allow companies to take it into account in their stress testing and capital planning. EIOPA should have the power to override the predictable triggers and formula if the situation so justifies. If there is no predictability, then companies will generally have to ignore it and consequently the CCP will not work.

- An **Extrapolation Methodology** to provide a way to extrapolate the interest rate curve beyond the point where the market is deep and liquid to avoid creating volatility in the valuation of long-term liabilities. We support the proposals of the European Parliament on the extrapolation methodology.

Solvency II stakeholders have been working hard for many years to achieve a risk-based prudential framework to ensure robust policyholder protection, strengthen the sector's attractiveness and increase its transparency. However, elements which may appear to be technical details can have enormous impact. It is important that the measures discussed above are included in Solvency II. Solvency II can deliver a leading secure global regulatory regime. Inclusion of the elements outlined above can help enable the insurance industry to continue to provide important economic and social benefits to Europe's citizens, to play a stabilising role in the economy and to support national governments in stimulating the 'real economy'.

The European insurance industry continues to engage in a constructive dialogue with all EU institutions. We remain at your disposal to provide further input where required.

Yours sincerely,

[signature]

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