Insurance Europe proposal for an alternative treatment of equity risk under Solvency II: strategic participations and long-term equity investment strategies

Introduction

Insurance Europe would like to take the opportunity to provide further comments on the treatment of certain investments in Solvency II, in addition to its recent contribution to the public consultation on the Capital Markets Union (CMU) mid-term review.

Insurance Europe believes that the current capital requirements for long-term investments in Solvency II are based on an inappropriate view of how insurers conduct their investment activities. Solvency II treats insurers like traders, assuming they will be forced to sell their entire portfolio in the case of market downturn. However, in practice and because of the long-term nature of their liabilities, insurers are not exposed to forced sales and can absorb portfolio losses. They are therefore exposed to long-term risks and not short-term value shocks. Against this background, important questions remain unaddressed by the European Commission, namely:

- 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?

The inappropriate calibration of capital charges is creating serious disincentives for the industry to invest in certain assets, thus hindering the normal flow of capital to the real economy and against the interests of policyholders. This does not appear to be compatible with previously stated policy priorities for the EC, and most notably improving the ability of the economy to finance itself and grow in a long-term and sustainable fashion.

Insurance Europe understands that addressing the issues above requires a significant amount of work as existing methodologies must be reviewed and alternatives devised and assessed. It appreciates that such investigations would be done in the context of the 2020 Solvency II review, and it strongly believes that the Commission should set up an Expert Group to investigate a range of long-term issues.

In the meantime, and as an important first step to the process above, Insurance Europe would like to put forward two proposals for changes in the equity risk sub-module, namely 1) adjusting the requirements for strategic participations and 2) allowing for an alternative treatment of long-term investment strategies. We look forward to discussing these proposals with the EC and to contributing further to both the 2018 and 2020 Solvency II reviews.

Proposals for changes in the treatment of equity-type assets

1. Strategic participations

The qualifying holding criteria for the strategic participations introduced in Solvency II are restrictive and inconsistent with market reality and the nature of these assets. Strategic participations cannot be evaluated by a lower volatility and a high holding threshold. A lower forward-looking short term volatility does not reflect the actual risks of such assets for insurers who take a long-term strategic view, and is extremely difficult to demonstrate.

The qualifying criteria should be built on the strong links between the insurer and the investee company. Emphasis should be put on the long-term holding capacity of the insurer and its commitment in the activity of the investee company.

Article 171 of the Solvency II delegated regulation should be reviewed as follows:

- The minimum ownership & control threshold for an investment to qualify as a strategic participation should be reduced from 20% to 10%.
  - This could be done by applying the criteria for 'qualifying holding' as defined in Article 13 (21) of the Solvency II Directive, rather than the criteria for 'participation' (as defined in Article 13 (20)).
- The criterion in Article 171 (a), requiring the demonstration of lower volatility in the next 12 months after acquisition, should be removed. This requirement is considered irrelevant, not applicable and in contradiction with the long-term horizon associated with the nature of strategic participations. The investor's willingness to hold over the long term cannot be tested via the one-year volatility metric. Moreover, estimating forward-looking volatility is difficult.
- A criterion aimed at testing the commitment of the (re)insurer in the activity of the investee should be added.

The following drafting is suggested for Article 171 of the delegated regulation:

[…] equity investments of a strategic nature shall mean equity investments for which the ~~participating~~ insurance or reinsurance undertaking <u>that owns a qualifying holding in another undertaking</u> demonstrates the following:

~~(a) that the value of the equity investment is likely to be materially less volatile for the following 12 months than the value of other equities over the same period as a result of both the nature of the investment and the influence exercised by the participating undertaking in the related undertaking;~~

(b) the nature of the investment is strategic, considering all relevant factors, including:

(i) the existence of a clear decisive strategy to continue holding the qualifying holding for long period;

(ii) the consistency of the strategy referred to) with the main policies guiding or limiting the actions of the undertaking;

(iii) the ~~participating~~ undertaking's ability to continue holding the ~~participation~~ <u>qualifying holding</u> in the related undertaking for long period;

(iv) the existence of a durable link;

<u>(v) the commitment of the insurance or reinsurance undertaking in the company's activities where a qualifying holding is held</u>

(vi) where the insurance or reinsurance ~~participating~~ company <u>that owns the qualifying holding</u> is part of a group, the consistency of such strategy with the main policies guiding or limiting the actions of the group.

2. Alternative treatment of equity in the equity risk sub-module for long-term investment strategies

Insurance companies put in place long-term equity investment strategies in line with their long-term liabilities and can maintain them, even in times of market stress. Equity investments can improve the performance of an insurance company in the service of policyholders and the economy. Insurers can optimise the return on their assets while controlling the risk. To achieve this, they can adopt a long-term strategy, which is essential for controlling the short-term volatility risk and achieving the risk premium and performance.

The current Solvency II capital requirement on equities is calibrated at one year and does not reflect adequately the willingness and ability of insurance companies to manage and hold their equity portfolio over the long term.

The long-term holding capacity of insurers in relation to equity investments should be taken into account in Solvency II. One way to achieve that is to create a specific risk module with specific treatment based on objective conditions ensuring long term holding and management of these assets, as proposed above.
An additional risk sub-module for Type 3 equities should be added in Article 168 of the delegated regulation.

Qualification for Type 3 equity treatment should be contingent on the weighted average duration of the liabilities exceeding an average of 6 years. This treatment is based on the same methodology introduced in the Solvency II Directive for the duration- based approach.

Type 3 equities shall refer to an equity holding or portfolio, held directly or indirectly, for which an insurer can demonstrate its willingness and ability to manage and hold it over the long-term.

- The undertaking's long-term holding capacity in relation to the equity portfolio shall be demonstrated by a prospective liquidity analysis.
- The demonstration can be based on criteria of ability of holding the equity portfolio over the long term are met even in stressed market conditions and described in the Own Risk and Solvency Assessment (ORSA)
- This is envisioned as a comparison between a deterministic scenario, projecting future financial flows under normal operating conditions and a stressed scenario, with shocks applied to the following variables: mortality, decrease in premiums and financial income, increase in incurred costs and an increase in lapse rate (ie discontinuance of a large portion of insurance policies).

The undertaking shall provide the following information to the competent authority to further demonstrate the long-term nature of the equity investment strategy:

- Investment policy, investment rules and arrangements with asset manager
- Asset-liability management policy
- Description of the internal process and procedures in place to ensure the long-term nature of the equity portfolio

The capital requirement for type 3 equities shall be equal to the loss in the basic own funds that would result from an instantaneous decrease in the value of type 3 equities. This instantaneous decrease shall be based on the following formula:

$$Inst\_Decrease\ (incl\ sym\_adj) = (39\% + sym\_adj) - \frac{(39\% + sym\_adj) - 22\%}{6} \times (average\_duration\ - 6)$$

Additional notes:

- Where the weighted average duration of the liabilities exceeds an average of 12 years, the instantaneous decrease in the value shall be equal to 22% (as is currently the case).
- Where the weighted average duration of the liabilities is below 6 years, the 39% capital charge, subject to the symmetric adjustment, shall apply (as is currently the case).

Worked example

Two examples of capital charges are presented below where the applicable symmetric adjustment is 0 and -4,26% respectively (as of November 2016). Following the application of the formula, the instantaneous decrease applicable to the value of type 3 is calculated as:

Duration	Example 1: Sym_adj = 0%	Example 2: Sym_adj = -4,26%
7	36,17%	32,62%
8	33,33%	30,49%
9	30,50%	28,37%
10	27,67%	26,25%
11	24,83%	24,12%
12	22,00%	22,00%

Estimating the parameters in the formula

The scope of the liabilities to be retained in the calculation of the weighted average duration shall include technical provisions, SCR and surplus funds.

- The SCR duration would receive a value in the range of 0 to 1.
- The duration of surplus funds should consider the link to the business as a going concern. One of two approaches can be adopted:
  1. Defining a standard duration for the whole market (eg 50 years) or
  2. Allowing each insurance company to estimate its surplus fund duration whereby a minimum standard duration will apply (eg 30 years)