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Comments on draft amendments to Solvency II delegated regulation related to long-term equity (Art 171a)

Insurance Europe welcomes that the European Commission has recognised the need to take action in the 2018 Solvency II Review to remove unjustified barriers to greater equity investment and included, in its proposed amendments to the Solvency II delegated regulation, a capital adjustment to better reflect the real risk for insurers' long-term equity investments.

Insurers invest in equities for their long-term performance arising from the combination of dividends and capital gains. While equities can exhibit significant short-term price volatility, where insurers can avoid being forced sellers of their equity holdings the actual risk they face is one of long-term underperformance of the asset and not the instantaneous fall in value. It is the long-term liabilities and the stable resources (including future premiums on a going-concern basis and own funds), combined with flexibility in terms of management actions that allow insurers to avoid being forced sellers.

"Long term" is therefore not the specific asset *per se* but the way to invest in and to manage the asset portfolio so that forced selling risk is avoided and a long-term perspective (and risk exposure) can be taken.

Insurance Europe strongly supports the 22% as an appropriate capital charge for this kind of "long-term" equity investment risk.

However, the proposed Article 171a has economical and theoretical flaws and will not work in practice. Having assessed the proposed text**, we do not believe that all criteria are relevant, nor that any insurer will be able to meet them**. The objective of Article 171a and the criteria it sets should be focused on ensuring the equities in question are not subject to material risk of forced selling, as this is the economic and prudential rationale behind the calibration. Additional criteria beyond this are irrelevant within a long-term framework and create unjustified constraints which damage the effectiveness and usefulness of the proposal.

We provide below further explanations of the specific elements in the draft article 171a that would prevent the text from being economically relevant and effective in practice. We further indicate the type of changes necessary to allow the article to be effective.

Specifically:

'Article 171a
Long-term equity investments
For the purpose of this Regulation, a sub-set of equity investments of the insurance or reinsurance undertaking may be treated as long-term equity investments if all of the following conditions are met:
(a) the sub-set of equity investment is included within a portfolio of assets and liabilities corresponding to clearly identified businesses of the insurance or reinsurance undertaking which is ring-fenced, managed and organised separately from the other activities of the undertaking, without any possibility of transfer;

Ring-fencing and no possibility of transfer are unjustified criteria. They would restrict the insurer's ability to carry out its duty of optimising risk and return, would restrict diversification and increase costs. Such criteria are inconsistent with a long-term investment framework and, in addition, unworkable in practice. The use of the term "sub-set of equities" also needs to be avoided and it should be made explicitly clear that the portfolio of equities qualifying as long-term can include both direct investment in equity by the insurer or indirect investment through collective investment funds.

In fact, insurers manage equity investments as part of diversified portfolios of assets including fixed income, property, etc which back liabilities. These assets are bought and managed based on insurers' ALM (asset liability management) strategies, and in line with insurers' risk appetite and internally set investment limits. This means that, from the outset, the long-term equity designation applies to a portfolio of equities and not to specific equity holdings. An insurer has a duty to both its customers and, where relevant, its shareholders, to optimise risk and return of its equity portfolio and this involves changing individual holdings over time based on the best information and forecasting available. The strategic asset allocation can be, and often is, long-term at portfolio level. This should be the focus of any criteria, while restrictions on changing individual holdings must be avoided.

Therefore, the text should refer to a portfolio of equities rather than a subset of equities. The term subset assumes that there is no situation where the entire portfolio of equities could meet the criteria for long-term equity treatment.

The long-term equity investment portfolio must be identified to ensure it is clear which portfolio of equities is designated as long-term for the purposes of Article 169. There is no need for a ring-fencing requirement beyond this portfolio identification requirement.

Ring-fencing has two objectives:

1. protect the policyholders in case of insurance undertaking's failure,
2. compel the insurance undertaking to redistribute technical and financial benefits exclusively to the policyholders within the ring-fenced portfolio.

The second objective of segregation in the redistribution of technical and financial benefits is clearly not an objective of the long-term equity calibration. The first objective is already at the core of the existing Solvency II framework and the supervisory process. In the context of long-term equity calibration, it can be strengthened through criteria to confirm the portfolio is not materially at risk of forced selling.

The ring-fencing proposal, underlined by the impossibility of transfer, is in many cases simply not possible because it would break mutualisation/sharing of returns requirements embedded in the business. Ring-fencing also limits diversification, which is a core feature of the business model and beneficial to customers.

Finally, to meet the ring-fencing requirement insurers would have to restructure existing products and asset liability portfolios, which in turn would require implementing new specific financial, accounting and underwriting rules as the ring-fenced portfolio would be "an undertaking in the undertaking". Insurers would in many cases not be able to restructure in this way; even if possible, significant initial and ongoing operational costs would be triggered by such changes, leading to an outcome that is not in the best interest of neither customers nor shareholders. Where ring-fenced assets and liabilities already exist in the balance sheets, e.g. as regards pension risks, there is already a possibility to benefit from a reduced shock for equities with article 304 of the directive, so that the proposal would have no added value in that situation. Finally, the legal framework of ring-fencing is not harmonized at EU level and could make the proposal non-applicable in some national jurisdictions, and this in itself would challenge the level playing field.

Insurers often invest through collective investment funds as well as or instead of through direct holdings. The text needs to clarify that equities held through such funds can be part of the equity portfolio qualifying for long-term calibration.

(b) the average holding period of equity investments in the sub-set is higher than the average duration of the liabilities held within the portfolio, and exceeds 12 years;

The average holding period of 12 years as defined in the draft text is not conceptually relevant and not practically workable. This criterion should be removed. Criterion e (see below) is sufficient.

Although insurers typically have investment policies and strategic asset allocations based on a long-term horizon, it is important to avoid requirements to hold specific equity holdings or equity funds for a minimum number of years – either related to the liability duration or a minimum of 12 years. Requiring minimum holding period per equity investment effectively imposes a "passive asset management system" without regard to actual risks and performance potential. Insurers need to be free to apply dynamic management of assets in order to optimise risk/return in the context of the customer needs, the insurer's risk appetite, the market information and assessment of the long-term prospects for the particular equity holding. There is no contradiction between a long-term investment strategy and dynamic asset management – in fact setting a requirement for minimum holding period for individual equity positions would contract the prudent person principle, fiduciary duty and the requirements on good risk management.

Then, further evidence that a requirement that holding period of equity investments be higher than the liabilities does not work can be seen by taking for example pension products whose duration is around 50 years – this would mean that buying new equity would be balanced by equity held for more than 100 years. Even reduced to a 12 years horizon, the threshold would imply a holding of assets for more than 24 years. This is clearly not an appropriate requirement and could have unexpected consequences on liquidity of equity markets, against the goals of CMU.

Finally, there is a technical flaw in EC's proposal. On the one hand, the EC proposes to compare a retrospective indicator (the average period of effective holding of assets) with a prospective indicator (the duration of liabilities, i.e. the future residual lifetime of the liabilities). However, the key requirement should be to assess whether an insurer can be subject to forced sales of assets. For this purpose, Insurance Europe advocates strongly for replacing this criterion by a liquidity test. A liquidity test seems to be the best way to deal with the issue as it allows for a holistic approach to confirm no material risk of forced selling. The liquidity test should focus on those scenarios which result in actual cash outflows and risk affecting the ability of insurers to pay out claims or provide contractually-agreed benefits to policyholders.

Insurance Europe suggests that an adequately designed liquidity test could work perfectly. The elements of the liquidity test could be the following:

- a given time horizon over which the insurer should demonstrate that it is able to remain in a situation of net positive cash flow even in adverse situations;
- consideration of the cash flows of assets, insurance obligations (including future premiums on a prudent basis for going-concern issues) and cash flows (e.g. dividends, debt coupons, etc.) rising from own funds (equity and debt);
- testing on the basis of a deterministic adverse scenario, combining both asset and liability distortions: these shocks could rely on the identified risks with a calibration on a time horizon consistent with financial cycles (e.g. from 5 to 8 years);
- full consideration of the management actions;

On the basis on the above, the exposure of the insurer to forced sales of long-term equity will be identified.

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

The scope should be extended to include OECD equities.

Insurance Europe welcomes that the scope of the proposal includes both listed and unlisted equities as this recognizes the benefit of diversification between different types of equities. Insurance Europe recommends that the EC also recognizes the geographical diversification between equities as key in risk mitigation. In fact, reference to OECD is already included in other articles relating to listed equity, infrastructure, STS securitisation and excluding it here is unnecessary and inconsistent.

(d) the insurance or reinsurance undertaking demonstrates to the satisfaction of the supervisory authority that its solvency and liquidity position, as well as its strategies, processes and reporting procedures with respect to asset-liability management, are such as to ensure, on an ongoing basis and under stressed conditions, that it is able to hold equity investments for a period which is compatible with the requirements of point (b);

Insurance Europe calls for the deletion of the mention "*to the satisfaction of the supervisory authority*" as the assessment of exposure to force selling can be clear enough to avoid the need for prior approval.

Prior approval should be avoided as it creates additional work and can result in delays. And above all it does not bring any improvement to the supervisory process nor to policyholder protection. The legislator and the regulator make the rules *a priori* and the supervisor controls *a posteriori*. The application of the tailored long-term equity capital charge would become part of the supervisory reporting and dialogue, as is the case for qualifying infrastructure assets.

e) the asset-liability management and investment policy of the insurance or reinsurance undertaking states the undertaking's intention to hold the sub-set of equity investments for a long period.

It should be clear in the text that this requirement applies at portfolio level, and not at the level of individual holdings.

Insurance Europe agrees with the EC that risk management and internal policies (both ALM and investment policies) must consider the challenges of long-term equity investment management. However, as highlighted above, these must be applied at portfolio level and reflect the intention to manage the equity portfolio, as a whole, for a long period.