EIOPA-IRSG-13-09

IRSG Opinion on technical issues related to long-term financing

Introduction and scope

The adequacy of funds available to be applied for long-term investment of a broadly infrastructural character is a subject of continuing interest to economic policymakers[1]. Specifically in the European context, the active interest of the European Commission was reflected in a 'green paper' (consultation document) in March 2013[2].

These and other papers acknowledge that the regulatory and accounting frameworks applying to insurance and to pensions may have a positive or negative influence on the appetite of insurance companies and pensions funds for long-term investment. This linkage apparently provided the rationale for a request to EIOPA from the Commission (to reconsider elements of the calibration and design of the Solvency II SCR standard formula) in the latter part of 2012[3] and certain of the issues were addressed in an EIOPA paper published recently[4].

The Insurance and Reinsurance Stakeholder group (IRSG) is of the opinion that technical aspects of regulatory and accounting frameworks can affect the availability for long-term financing purposes of funds managed by insurers as discussed below. It is appropriate for EIOPA to address such issues on an ongoing basis with a view to sustaining an appropriate balance as between returns on insurers' investments and security of long-term commitments to consumers. While the Commission rightly addresses a very wide range of matters in its consultation, this opinion confines itself to those which it understands to be in the remit of EIOPA.

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[1] For example *Long-Term Finance and Economic Growth* Group of Thirty 2013

[2] *Long-term Financing of the European Economy* Brussels 25.03.2013 COM 2013 (150) final

[3] http://ec.europa.eu/internal_market/insurance/docs/solvency/20120926-letter-faull_en.pdf

[4] EIOPA Discussion Paper 13/163 *Discussion Paper on Standard Formula Design and Calibration for Certain Long_Term Investments* 8 April 2013

Conclusions

The IRSG acknowledges long-term financing to be an issue which is macroeconomically important in present economic and financial circumstances. It affirms the desirability of insurers and pension funds being in a position to consider non-traditional long-term assets in the context of asset-liability management (ALM) mainly on their economic merits. Accounting and regulation should be neutral in their impact on investment decisions.

The IRSG is of the opinion that the value of liquidity options (mandated by certain national laws) in insurer liabilities may be subject to question because of the destabilising effects on ALM and this issue should be further explored by EIOPA and/or its members. This exploration should consider whether requirements for clearer and more succinct information on charges and on intended investment policy may be preferable from a consumer protection viewpoint to mandatory switching rights.

The IRSG suggests that EIOPA explores whether flows of long-term funds for investment might be marginally encouraged without detriment to consumer security by extending 'dampening' within the Solvency II SCR standard formula from equity risk only to a wider range of risk factors bearing on long-duration liabilities. Similarly the calibration of any 'volatility balancing' adjustment to own funds may have regard to the impact on appetite for long-term investments. The IRSG also recommends that EIOPA should keep the elements of standard formula capital requirements related to specialised long-term asset classes under continuing active review.

Finally the IRSG notes without any recommendation that the move to a market-consistent paradigm as reflected in Solvency II and IFRS 4 can (unless implemented with great care and making use of contra-cyclical tools such as volatility balancers and dampeners) have a negative effect on availability of long-term financing. This will need continuing careful attention.

Discussion

A real question at present

Traditionally insurers and pension funds were significant providers of long-term financing through debt on and investment in real estate, unquoted companies, private and public infrastructure projects and more. For longer than the last 30 years before 2008, however, there has been an observable trend for institutional investors to concentrate increasingly on quoted equities and debt (including sovereign debt) while the banking sector adapted maturity transformation and made use of wholesale funding to provide increasing amounts of long-term finance. The crisis and its consequences for maturity transformation, wholesale funding and the need to improve capital ratios have sharply reversed this trend so far as banks are concerned and are currently revealing a significant funding gap[5,6].

[5] See for example *Plugging the global infrastructure funding gap* The Banker 28 May 2013

[6] See section III.3 of *Funding the Future* Insurance Europe/Oliver Wyman June 2013

Insurers certainly are exploring actively whether or to what extent investment in non-traditional asset classes is appropriate in the post-crisis financial environment. There are however hurdles which the IRSG suggests are the subject of active boardroom debate:

- Whether or to what degree the risk-adjusted economic rewards of long-term investment in non-traditional classes justify change;
- Acquiring or developing the requisite investment governance and risk management skills;
- The degree to which (insurer) liabilities are of stable duration; and
- Accounting and solvency treatments of long-term assets and/or liabilities.

The economic judgements and risk management techniques are properly matters for insurance enterprises themselves, but liability instability and accounting/solvency treatment may artificially inhibit long-term investment.

Terms of insurance and pension contracts

A principal influence on insurers' and pension funds' appetite for long-term investment is the degree to which their commitments are predictable or illiquid. For example, contracts for retirement benefits may persist for as long as 80 years or more. However it is quite common for insurance policyholders to be granted by certain national laws contractual options allowing them to liquidate on stipulated terms (including by transfer to another insurer) part or all of their investment in the short term. Such options may be mandated by regulators or other authorities to allow or encourage switching behaviours as a misguided form of consumer protection.

The IRSG is of the opinion that the value of mandated liquidity options which preclude recovery of losses on the sale of the corresponding assets are subject to question and should be further explored by EIOPA and/or its members. It would appear that only minorities of policyholders take advantage of such options, but the options may inhibit the otherwise natural ability of life insurers to invest for the long-term. From the perspective of protecting the customer, it may be that requirements for clearer and more succinct information on charges and on intended investment policy may be preferable to switching rights.

Capital requirements (SCR standard formula)

With one important exception, the modules of the SCR standard formula in Solvency II are calibrated to an estimate of that annual variation in the underlying risk factor which has only a 0.5% probability of being exceeded (i.e. one expects to be 99.5% confident that the required capital will cover any variation over a year '99.5% one year VAR'). This calibration was preferred, with general support from stakeholders, to possible alternatives such as a target confidence level that liabilities would ultimately be discharged in full. It is best suited to risks which appear to be random without any secular or cyclical trend (for example the risk of earthquake or of being struck by lightning).

With the benefit of some hindsight, this calibration of the standard formula can introduce severe procyclicality when applied to cyclical factors in the context of a 'fair/market-consistent'

valuation of the balance sheet. Such procyclicality, which increases directly as the duration of assets/liabilities increases, is independent of whether the cycle is short and regular or long and irregular. It relates particularly to financial and economic risk factors, including equity values, credit spreads, interest rates and inflation.

It seems clear that if the traditional life insurance and pensions model of pooling the retirement savings of consumers to create funds for long-term investment is to be sustained within a fair valuation paradigm, then capital requirements for market risk must dynamically respond to cyclical influences. This is particularly important at present when for example interest rates generally in the major currencies are well below historical equilibria.

As matters stand, the only dynamically calibrated element of the SCR standard formula is the 'dampener' applied to the capital requirement for equity market risk in respect of certain very specific long-term liabilities (the scope is unnecessarily narrowly defined). Although almost certainly insufficiently 'dampening' in practice to sustain really long-term holding of equity assets, the equity 'dampener' includes two features which could be part of the model for a much broader set of 'dampeners'

- It responds dynamically to where a risk factor (equity values) stands relative to historic trend; and
- Its application is linked to the duration of the relevant liabilities.

The IRSG recommends that EIOPA, as part of its ongoing consideration of the appropriateness of the currently envisaged standard formula, explores the application of similar dampeners to a broader range of cyclical risks including interest rate risk and credit risk. This exploration should have regard to whether or to what degree insurers' portfolios are exposed to (or insulated from) purely temporary market influences.

Granular capital requirements in respect of specific asset classes

The Commission has asked EIOPA to consider the effects of the standard formula requirements in respect of specific asset classes (for example private equity) on investment flows into such assets. This is a question on which it is difficult to form an ex ante view. The different requirements in respect of particular asset classes tend to be based on limited data which is not necessarily relevant to the future. On the other hand not to make some distinction (between for example quoted equity and private equity) could encourage insurers and pension funds to gravitate towards risk-seeking and thereby raise the overall level of risk in the system. IRSG strongly encourages EIOPA that, in order to avoid potential negative effects on financing availability for particular long-term asset classes, it should keep its requirements in respect of more specialised classes under active review.

Balance sheet measurement paradigm

Historically insurer and pension fund balance sheets (both for solvency assessment and general accounting purposes) were based on historical cost concepts. Indeed this continues to be the case quite widely within and beyond the European Union. However, there has been a sustained trend both in development of international accounting standards (for purposes of investor/stakeholder reporting) and in solvency assessment to move towards a 'fair value' or 'market consistent' paradigm for both asset and liability measurement.

Proponents of using fair value as a principal accounting measure argue that it affords stakeholders valuable information, while opponents argue that it introduces volatility of balance sheet quantities – assets, liabilities and own funds - which is poorly understood by stakeholders and may impair confidence in insurers' 'stewardship' role. To the extent that the latter view is held, it will discourage insurers and pension funds from both origination of long-term liabilities and investment in long-term assets. It is also more generally recognised by insurers and stakeholders that the present environment of historically low interest rates is far from an ideal time to change paradigm.

IRSG takes no view on the arguments for and against moving to a 'fair value' paradigm but notes that it may take several years for stakeholders to become familiar with fair value concepts during which time confidence may be impaired. This adds force to the importance of deploying contra-cyclical tools such as 'dampeners' within Solvency II.

Long term Guarantee Package

The IRSG notes that all of the Commission, EIOPA, the insurance industry and relevant stakeholders have been actively working on a package of measures with a view to ensuring as far as practicable that the use of a 'fair/market-consistent value' paradigm in the context of Solvency II does not give rise to destabilising volatility of insurer balance sheets. EIOPA reported its advice in relation to the measures appropriately to be adopted in this respect in June 2013[7].

While elements of the EIOPA advice are universally welcomed, there remain concerns as to whether the recommendations are sufficient to mitigate risks of procyclicality in current and possible future market conditions. Specifically the IRSG notes that the calibration of the formulaic volatility balancing adjustment mechanism newly proposed by EIOPA requires careful consideration. The combination of volatility balancer and dampened SCR should be designed to insulate solvency ratios from artificial volatility.

Pragmatic review

With hindsight, the sustained relatively benign and stable financial and economic climate which prevailed over the 15/20 years prior to mid-2007 was exceptional. Concepts of prudential regulation of the financial sector formed during that time have had to be revised because of unintended consequences exposed by both the 2008 crisis and the subsequent harsher and less stable economic climate. The IRSG encourages the Commission and EIOPA to be prepared to adapt flexibly so as to facilitate the natural function of insurers and pension funds as accumulating savers' funds for the purpose of long-term investment.

[7] Technical Findings on the Long-Term Guarantees Assessment EIOPA 13/296 Frankfurt 14 June 2013