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INVESTING IN LONG-TERM EUROPE: RE-LAUNCHING FIXED, NETWORK AND SOCIAL INFRASTRUCTURE

A CONFERENCE JOINTLY ORGANIZED BY THE ITALIAN BANKING INSURANCE AND FINANCE
FEDERATION, THE OECD, THE LONG-TERM INVESTORS CLUB AND CASSA DEPOSITI E PRESTITI
GROUP

WITH

THE EUROPEAN LONG-TERM INVESTORS ASSOCIATION, THE OFFICIAL MONETARY AND
FINANCIAL INSTITUTIONS FORUM, INTEGRATE, THE ITALIAN COUNCIL OF THE EUROPEAN
MOVEMENT

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The impact of Solvency II regulation on the ability of insurance companies to provide long-term financing: Issues for discussion

Dario Focarelli

Director General ANIA

Member of the Advisory Scientific Committee of the ESRB

Visiting Professor, Risk Management and Insurance, 'La Sapienza' Roma

Adjunct Professor, 'Tanaka Business School', Imperial College London

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Agenda

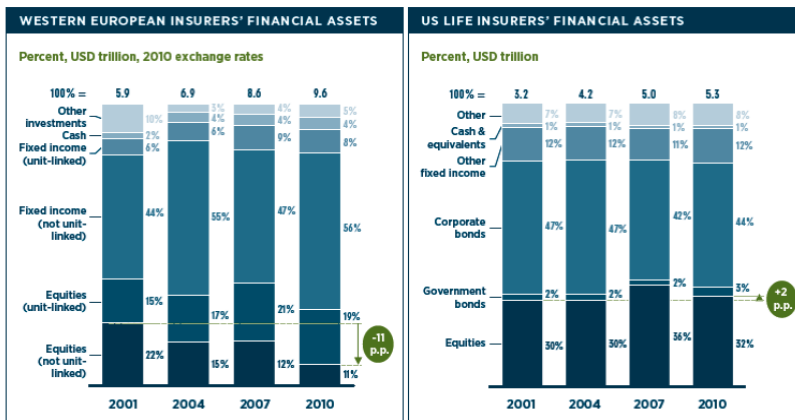
- a) Equity investments by Insurers
- b) A Market Consistent Approach for Solvency II ... but not in the US
- c) Concerns regarding the Solvency II approach
- d) The potential negative effects on the insurance business
- e) The tentative solution
- f) Avenues for economic research and policy agenda

Equity investments by Insurers

- According G-30 (2013) European insurers reduced their allocation to equities by 11 percentage points (almost 1 trillion euros compared to total assets currently amounting to 8.4 trillions euros) **from 2001 and 2010** , while in the US the share of equities in insurance portfolios remained almost flat
- This started as an internal risk management approach – encouraged by supervisors - after the collapse of Equitable Life (2000), a UK company which accumulated a disproportionate amount of equities in respect of guaranteed fixed returns to policyholders, and thus was not able to cope with the dot-com crash

European insurers have been decreasing their allocation to equities outside their unit-linked businesses since 2001, in contrast to US insurers

EXHIBIT 12



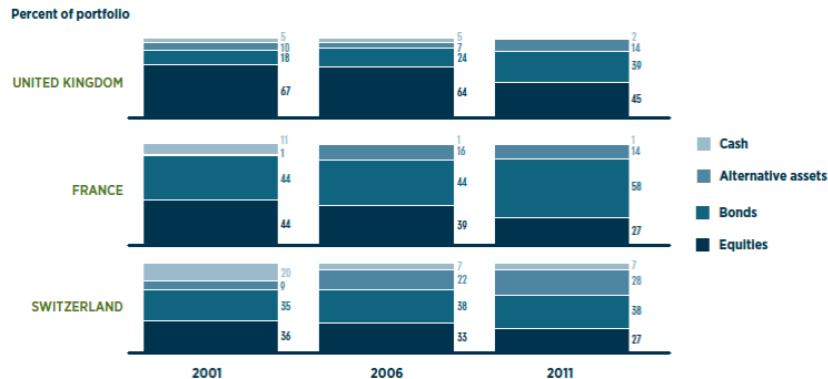
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute, "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape" (December 2011).

European pension funds have been shifting out of equity, toward bonds and alternative assets

EXHIBIT 11

EUROPEAN PENSION FUNDS ASSET ALLOCATION



SOURCE: McKinsey Global Institute, "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape" (December 2011).

A Market Consistent Approach for Solvency II ... but not in the US

- The trend has culminated in the adoption of a market consistent approach in **Solvency II**, which will determine solvency requirements for all European Insurers from 2016
 - Support for the move to risk-based framework for solvency capital remains strong, but there are **concerns that the market value approach is exaggerating the assessment of the market risk faced by insurers**, especially in relation to long-term business
- Looking at the rest of the world:
 - Australia and Switzerland are already using a market consistent approach to calculate capital requirements
 - Some regulators are considering using it, others such as the US are strongly against such approach
- With the development of the international solvency measures by the IAIS, the debate over the potential impact of a market consistent approach on the insurance business model and investments is becoming increasingly global

Concerns regarding the Solvency II approach

- Using market values may exaggerate the true exposure of the balance sheet to temporary market volatility and therefore force the company to hold significant extra capital buffers to cope with the large volatility
 - The “market consistent” value of liabilities is obtained by discounting future cash flow with risk-free rates (proxied by euro swap rates). During periods characterized by high volatility in financial markets, average asset values tend to decrease while “safe” assets will benefit from “flight to quality” effects, which will cause their market value to increase considerably
 - Thus, the capital position of insurers might deteriorate even if the adjustment of interest rates is only temporary and liabilities are due in a distant future (recent examples: 2008 corporate bond and 2011 government bond crisis)
- Using a 1 year VAR for assets which can be held long-term may exaggerate the exposure to market movements and lead to capital requirements being set too high than required, at least for specific asset classes
 - (Mladina, 2014) *“equity returns show more volatility and tail risk at short horizons than at long horizons”*
 - *What do we know for infrastructure, real estate, and securitization ?*

The potential negative effects on the insurance business

- Insurers would therefore have a clear incentive to:
 - Reduce the level of guarantees to policyholders
 - Shorten the maturity of their assets
 - Shift towards high rated government bonds where market price volatility is very low

The tentative solution

- Adjustments were made to the market consistent approach to better reflect the long-term nature of the business and allow insurers to continue to offer long-term guarantees backed by long-term investments:
 - For example, on the balance sheet measurement, adjustments have been introduced to the discount rate used to value liabilities (e.g. the “Matching Adjustment”, “Volatility Adjustment”)
- **Concerns remain over the effectiveness of the adjustments as these are regarded to be very conservative in their calibration and restrictive where they can be applied**
- Rather than seen as legitimate improvements to better reflect the true risks and economics of the business these adjustments are seen by some as aberrations from the pure and correct market approach (Ayadi et al., 2012).
- But the “purity” of a market approach is now put under serious investigation not only from practitioners

Avenues for economic research and policy agenda

- To me the new theoretical framework should be consistent with the results of the seminal paper by Cochrane (2011)

“Discount-rate variation is the central organizing question of current asset-pricing research.

Previously, we thought returns were unpredictable... [now evidence shows that] high prices, relative to dividends, have reliably preceded many years of poor returns. Low prices have preceded high returns.

This pattern of predictability is pervasive across markets ...

For bonds, much variation in credit spreads over time and across firms or categories signals returns, not default probabilities. ...

Incorporating discount-rate variation affects finance applications, including portfolio theory, accounting, cost of capital, capital structure, compensation, and macroeconomics.”

- Academic research is needed
 - to improve the general understanding of how effective the insurance long-term business model can be in reducing market risk
 - to improve the market consistent framework so it captures better the real risk exposures and therefore solvency requirements. In more formal way, to design a regulatory system no longer based on the market efficiency (Black and Scholes) but on Cochrane’s results