



# Challenges and opportunities of policymaking for insurers' asset allocations

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## 1 Who we are

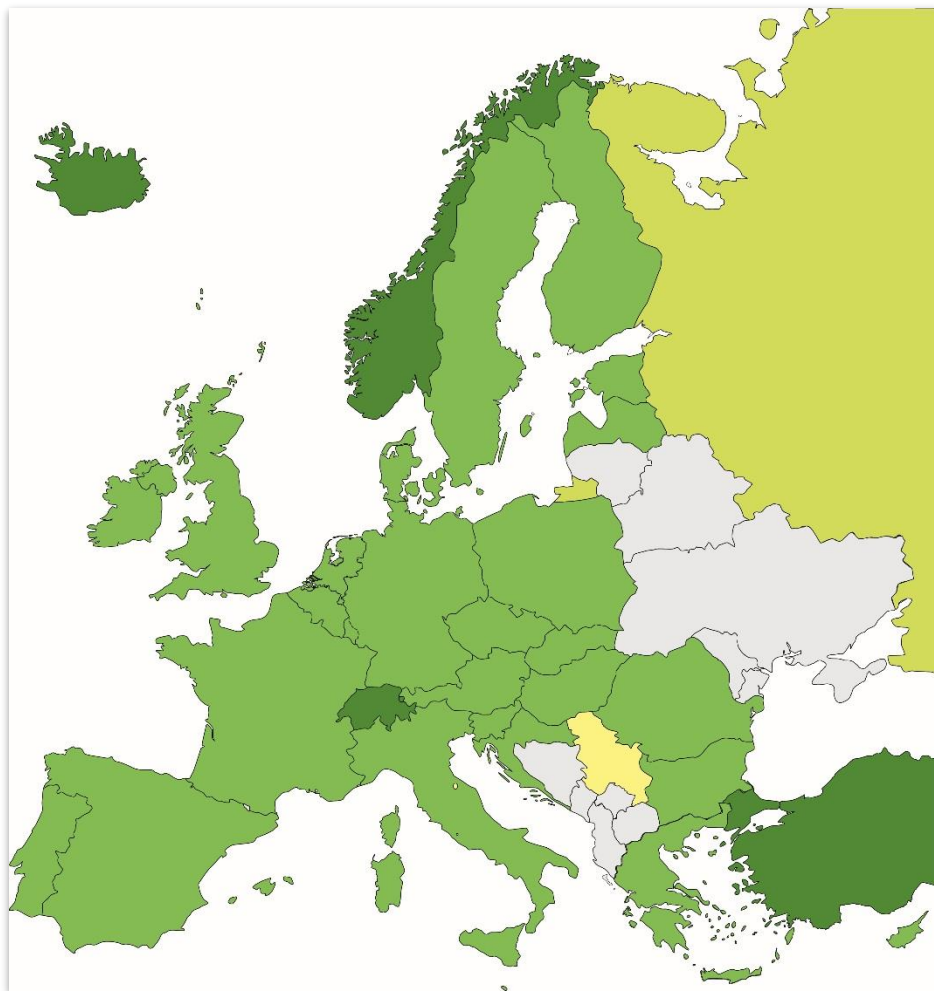
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# Insurance Europe



- Insurance Europe represents around 95% of European insurance market by premium income
- European insurance market: largest market in the world (35% share in 2013)
  - €9.9trn investments
  - €1.2trn in premiums
  - €0.9trn in claims
- 34 members (national associations)
  - **27 EU member states**
  - **5 non-EU markets** (*Switzerland, Iceland, Norway, Turkey, Liechtenstein*)
  - **2 associate members** (*Serbia, San Marino*)
  - **1 partner** (*Russia*)

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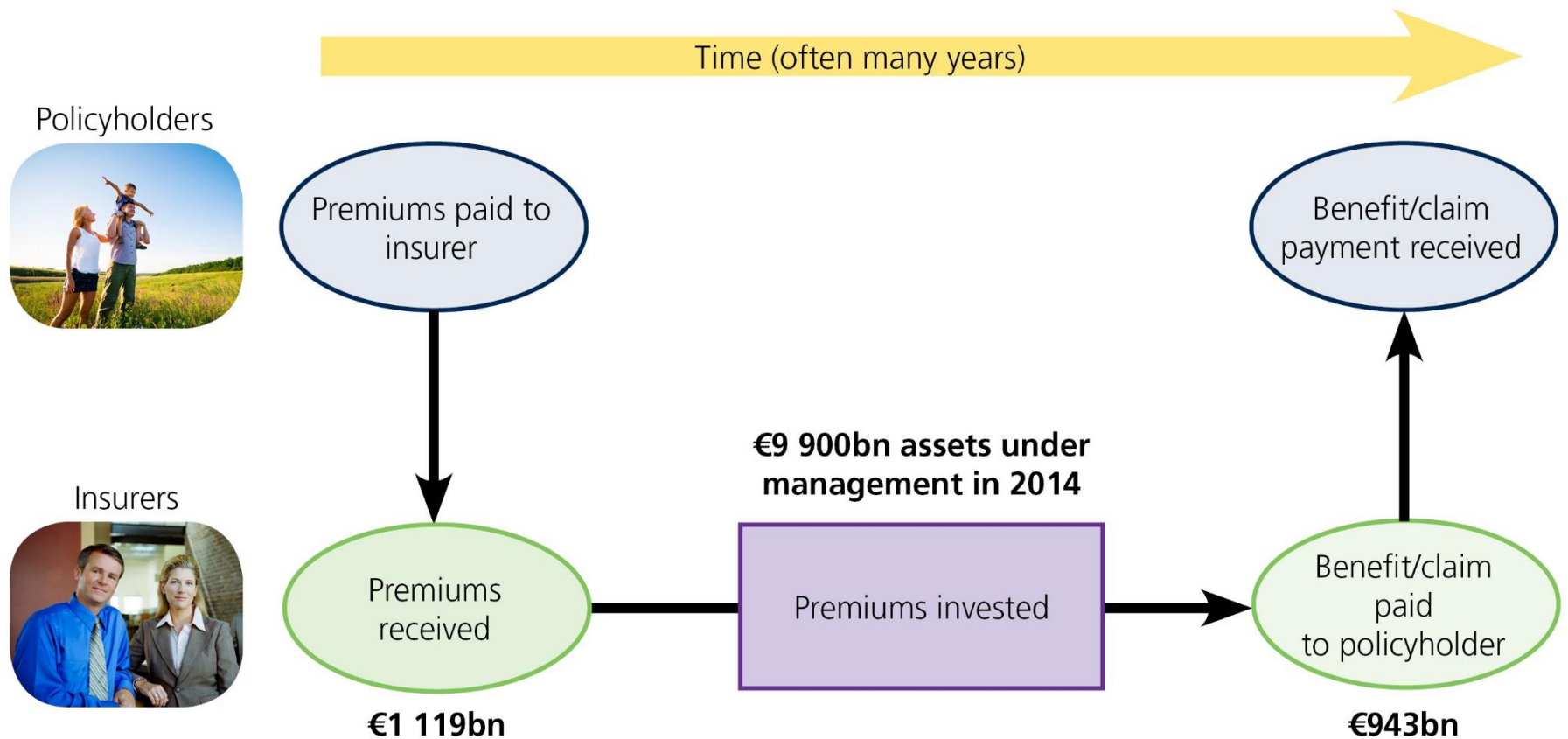
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# Investing is a consequence of our business model



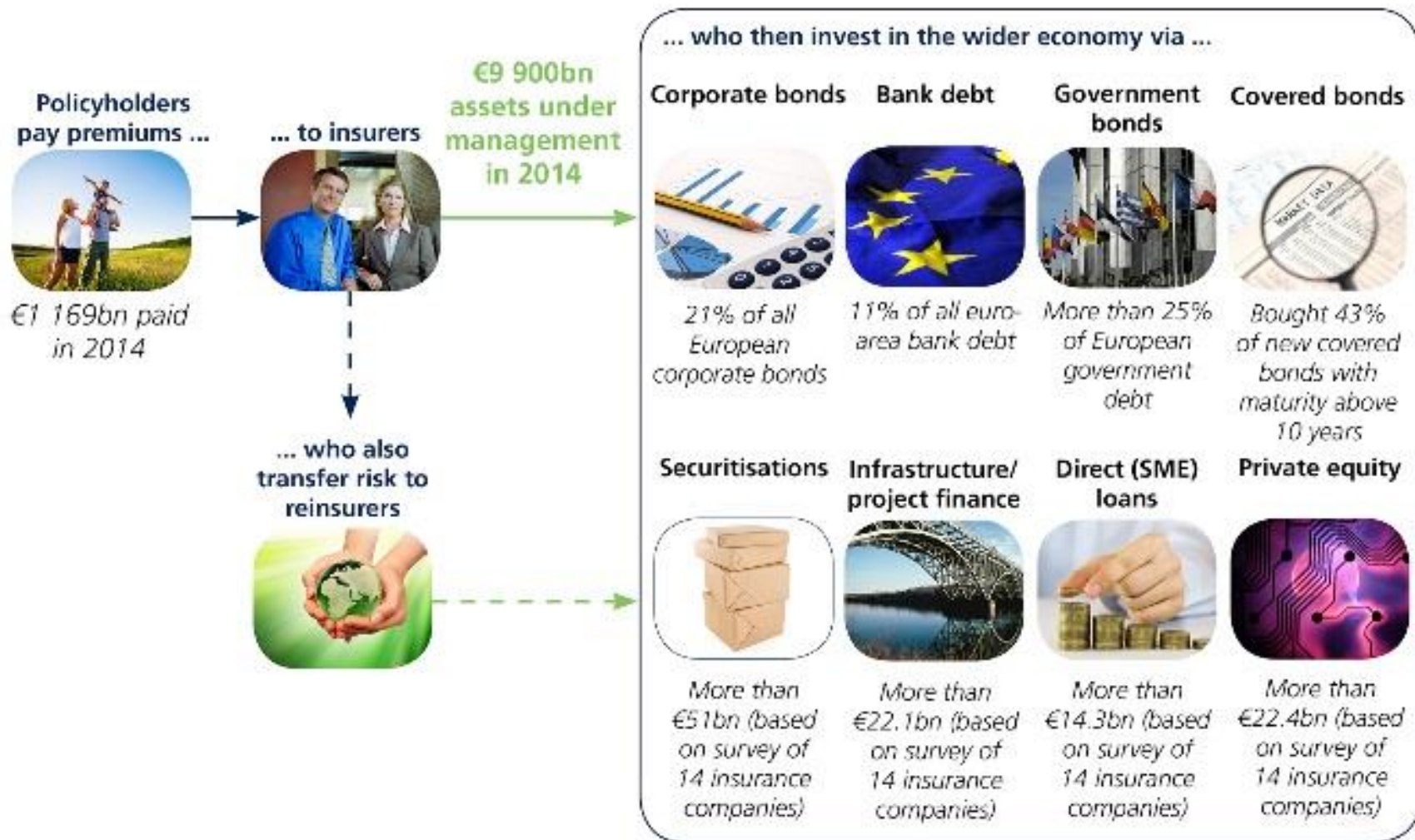
## . . . and creates significant benefits

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- Benefits for policyholders
- Benefits for economic growth
- Benefits for financial stability



# Largest European institutional investors



Source: Insurance Europe analysis. The 14 insurance companies that participated in Insurance Europe's survey represent €3.8trn in assets under management. The survey is based on 2013 data.



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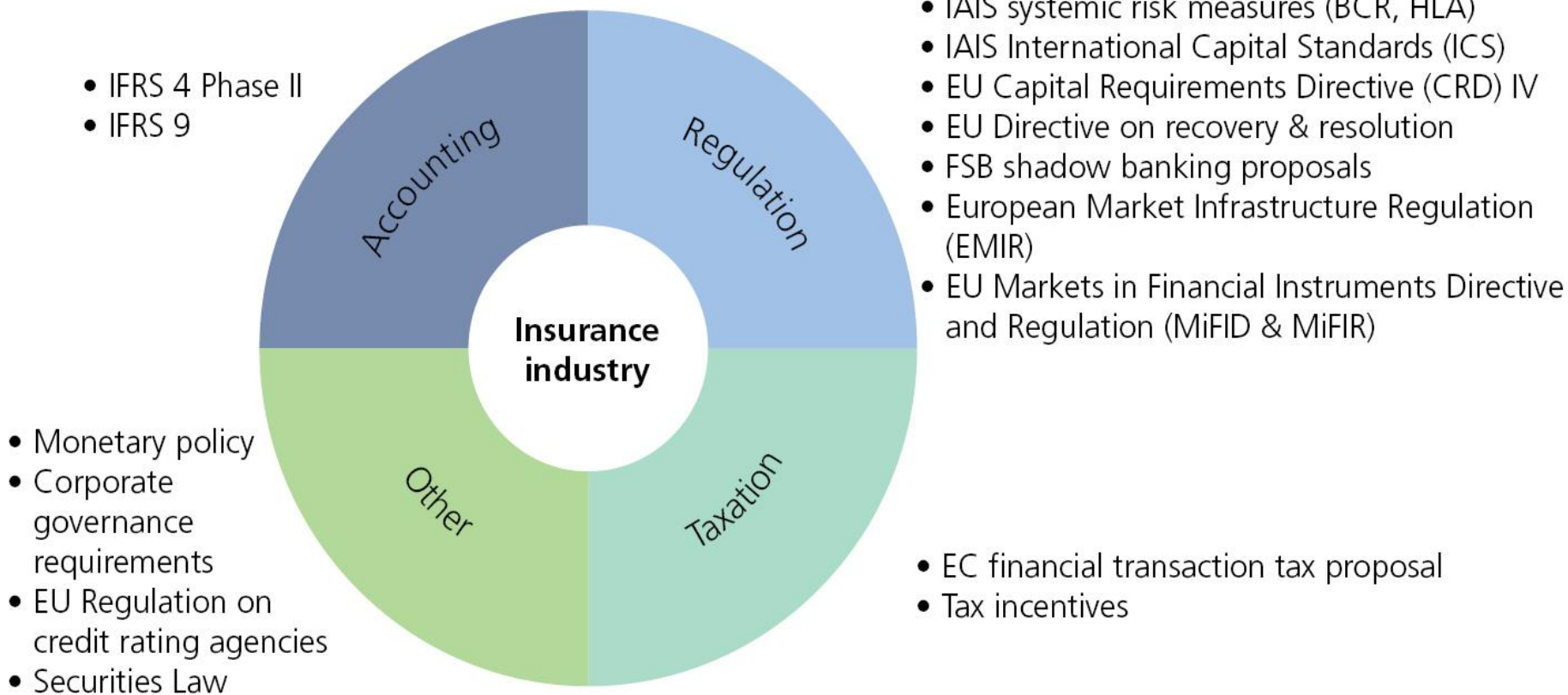
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# Many policy developments impact insurers



# Solvency II: huge change and improvement

## Solvency I

- Cost accounting valuation, limited rules on assumptions for liabilities.
- Very simple factor-based approach for measuring risks.
- Solo-based regime.
- Relatively low minimum solvency requirements.
- Little governance and risk-management requirements.
- Limited reporting requirements.
- Limited powers to intervene before failure.
- 199 pages covering 13 directives.

## Solvency II

- Market valuation and best-estimates liabilities.
- Risks measured by sophisticated internal models or standard approach, 28 risk types.
- Solo and group based regime.
- Minimum capital requirements (MCR) & much higher Solvency Capital Requirements (SCR).
- Extensive governance and RM.
- High requirements, >150 reporting templates.
- Ladder of intervention: before material risk of failure.
- >3000 pages.

# The long-term issue: understanding insurers' concerns

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- Long-term and predictable liabilities allow insurers to:
  - Hold assets long-term (or to maturity for bonds) and have control over when/if to sell
  - Avoid losses due to forced sales
  - **Therefore insurers can reduce or eliminate exposure to temporary declines in asset prices**
- Unfortunately Solvency II **generally assumes insurers act as traders** and are exposed to the same volatility of market prices
- This is not at all the reality and it matters because it has a **huge impact** on how Solvency II measures market risks for insurers

# The wrong measurement can artificially exaggerate overall capital in two ways...

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$$\begin{aligned} &\text{Solvency ratio} \\ &= \\ &\frac{\text{Available Capital}}{\text{Required Capital}} \end{aligned}$$

## Indirect

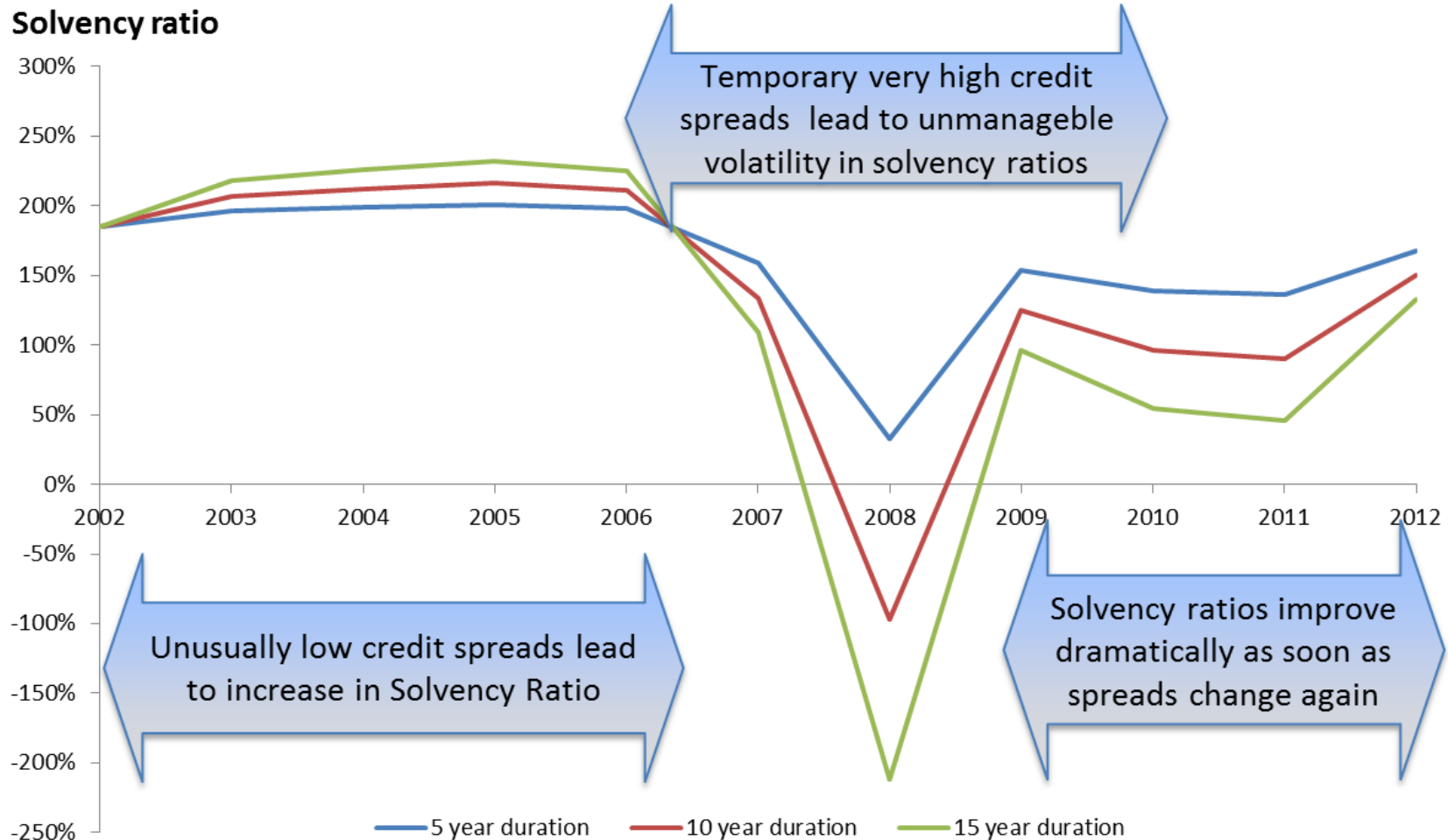
- A trading view ignores link between assets & liabilities
- This creates artificial volatility and need for additional capital buffers

## Direct

- A trading view exaggerates the true market risks by requiring capital for the full market volatility

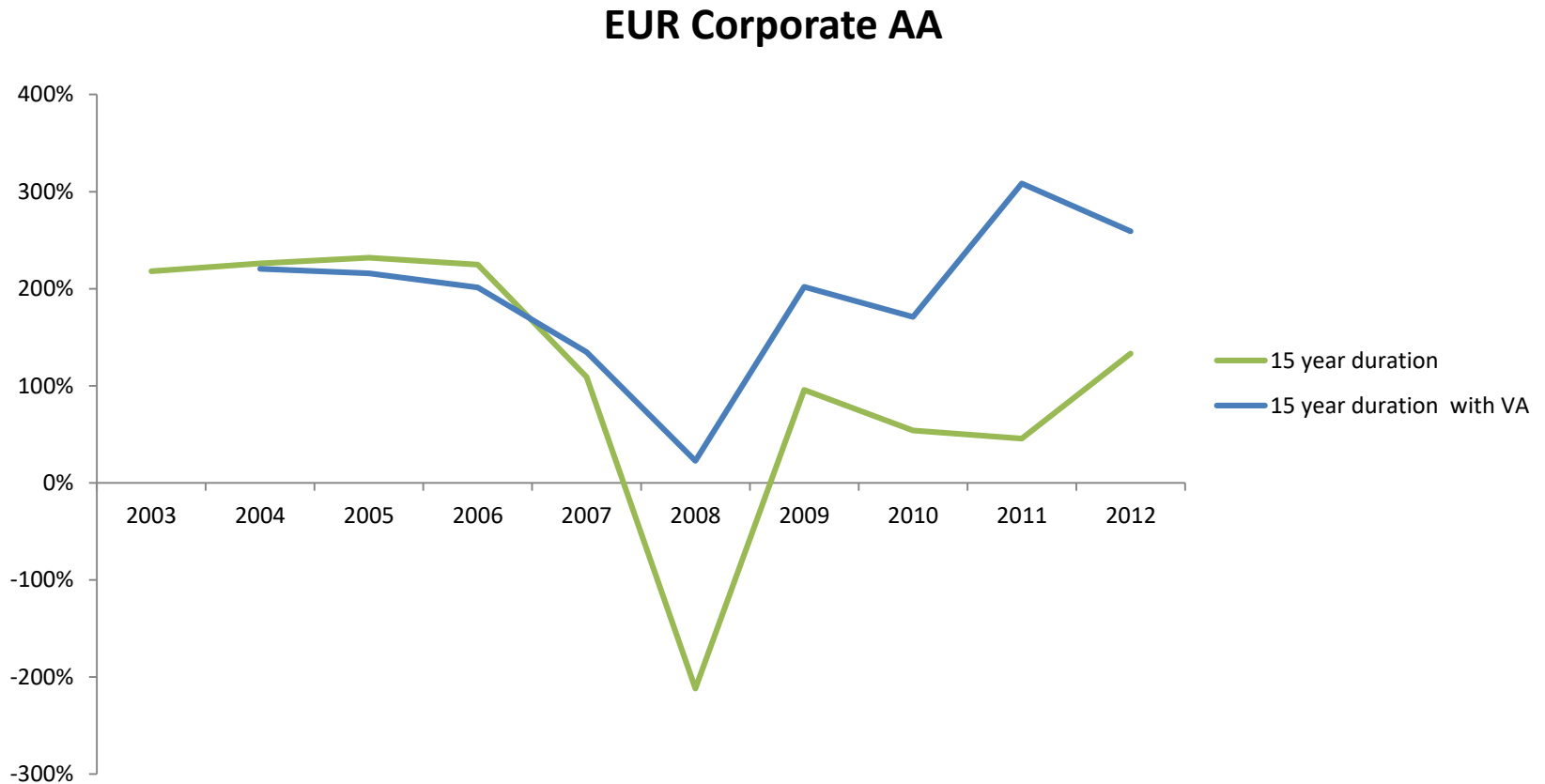
# With no LTG measures volatility would be completely unmanageable

- 3 simplified insurance companies – with fully cashflow matched “AA” assets backing 5, 10 & 15 year liabilities



# The volatility adjustment addresses the problem only partially

- In the case of 15 years duration the volatility adjustment (VA) helps to dampen the effect of spikes in spreads but there is still significant volatility that remains in the balance sheet.



# How should Credit Risk for bonds be measured for insurers?

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- Trading view: Based on Credit Spreads
  - “Extreme” price change AA bonds 2007 – 2008 = **30%**
- Long-term view: Based on credit default losses
  - “Extreme” losses on AA bonds 2007 – 2008 = **0.2%\***



# Example: measuring risk for securitisations

- Capital for 5-year AA STS securitisation compared to actual losses during crisis

Actual default during entire crisis period	0.14%
Original Calibration (QIS5, 2009)	80%
EIOPA proposal for High Quality securitisations (end-2013)	42.50%
Actual calibration chosen for Solvency II	15%

} Risk for Long-term Investor

} Trading approach: Economically wrong and a barrier to investment even with improvements made by Commission

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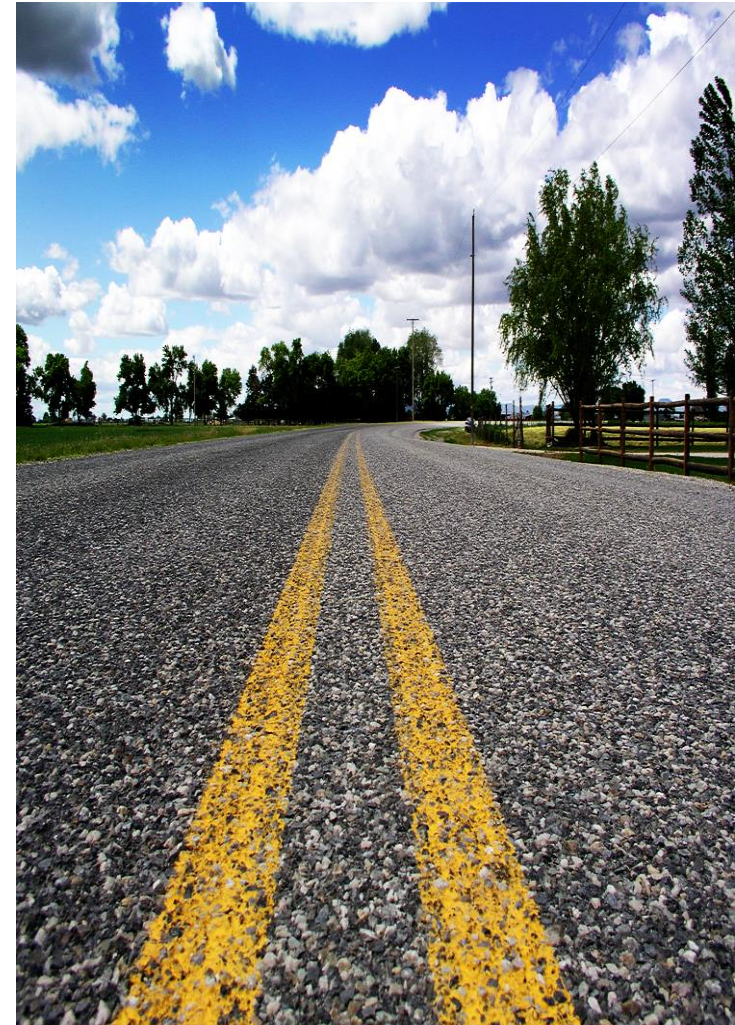
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# Investment Plan for Europe

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Launched in end-2014 - 3 key areas of interest for insurers:

1. Increase **supply** of infrastructure assets for private investors
2. Provide **public support** where needed
3. Address regulatory barriers – **Capital Markets Union**



# Some progress, but more ambition needed

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- Supply of infrastructure
  - Remains **limited** across EU member states
  - Lags behind insurers' willingness and ability to invest
- Public support
  - Worrying examples of **crowding-out**
- Regulation (Solvency II)
  - Limited changes, **more is needed**

## AA infrastructure bond

Original Calibration (Oct. 2014)	15.5%
Initial EIOPA proposal (July 2015)	13.5%
Final calibration (Sept. 2015)	<b>9.3%</b>
Calibration based on actual credit performance	5.9%

# **Polymakers need to address the right questions**

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- Is there a difference between measuring exposure to long-term default risks and exposure to short-term trading risks?
- 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?

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# Getting the regulatory balance right is challenging, but vital

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- Design and application of insurance regulation should focus on:
  - Identifying and achieving right outcomes
  - Avoiding unintended consequences
  - Considering the impact on the economy



# **Good regulation is vital, but bad regulation can be as damaging as too little regulation**





# Bad regulation can be worse than too little (1)

Titanic sank in 1912.

The ship was in compliance with regulation at the time.

Over 1500 died.

Key cause for deaths:  
not enough lifeboats



## Bad regulation can be worse than too little (2)

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- Led to "lifeboats for all" movement and new regulation came into force in March 1915.
- During the development of the regulation, the shipping industry had warned that some vessels would turn 'turtle' if you attempted to navigate them with this additional weight – concerns were not heeded.
- Many ships had to be retrofitted with more lifeboats to comply, including SS Eastland, a US passenger ship used on the Great Lakes.

# Bad regulation can be worse than too little (3)

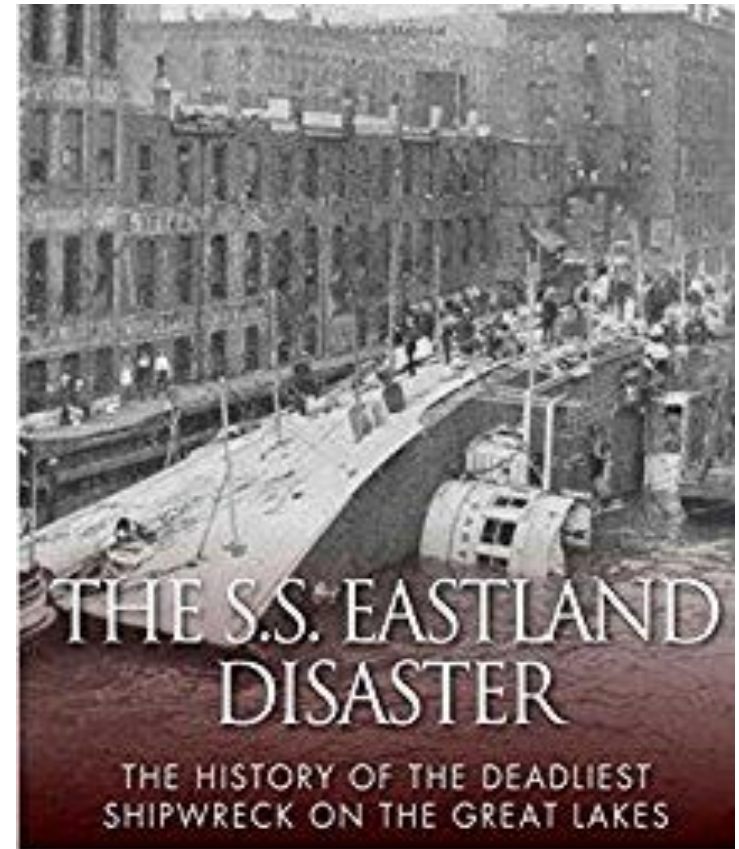
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Eastland sank in 1915, a few meters from the dock.

Nearly 850 died.

Key cause for deaths: too many lifeboats, making ship top heavy and prone to capsizing.

For the SS Eastland, even though stability was already known concern - no tests were conducted to determine how the additional weight affected the boat's stability.





**For more information**

**[www.insuranceeurope.eu](http://www.insuranceeurope.eu)**

**Twitter: @InsuranceEurope**

