ALLIANZGI INSURANCE SNAPSHOT

Solvency II review: a game-changer for Long-Term Equity investments?

Equities have not been the most favoured investment class for insurance companies lately. After the deregulation of the insurance industry in 1994 and during the bull market of the late 90s, German insurers, for example, added up to 35% of equity to their balance sheet. Despite local GAAP (Generally Accepted Accounting Principles) allowing for hidden reserves to be accumulated over the years, when the dot-com bubble burst in 2001 some insurers came under significant pressure. Since then, this asset class never really recovered: it is seen as simply too risky and volatile!

In hindsight, strategic and long-term equity investments make a lot of sense, providing diversification benefits and attractive returns. Nonetheless, the introduction of Solvency II in 2016 did not do much to help change the overall perception of equities: a capital charge of 39% or even 49% is too much for insurance companies aiming to optimise their overall Solvency Capital Requirement (SCR). This is especially true for those insurers that struggled to keep their Solvency ratio in place during the last decade of low interest rates.

Status Quo

Germany and others:

- Limited to no implementation success of the LTEI Art. 171a.
- Local regulators have divergent positions and some quite restrictive interpretations of the term "managed separately".

France:

- French Insurers apply the LTE.
- Approach is based on the ability to separate accounts under local GAAP, by "ring-fencing" portfolios with separate accounting and Profit & Loss calculations, profit sharing rules and an Asset Liability Strategy at liability portfolio level.
- No pre-approval from the local supervisor required.

Of course, some investment has been made into mainly global equities and also private equity as a diversification measure—albeit in homeopathic doses. In contrast, the Scandinavians are the exception to the rule. They have always kept a significant equity allocation of around 15–20%.

Evolution of the equity risk treatment

From the start, it has been obvious that the short-term focus on market risk under Solvency II is in conflict with the European Union's objective to facilitate long-term sustainable growth. Life insurers are a major investor group and risk-bearers in financing, e.g., long-term infrastructure and green energy transition projects. Without compromising on the prudence of capital requirements, first, qualifying criteria for infrastructure investments and, second, specific rules for qualifying unlisted equity portfolios (QUEP) and long-term equity investments (LTEI) have been introduced.

Long-term Equity Investments (LTEI)

Comparing the various rules introduced—on the one hand, the capital relief offered by the LTEI, i.e., a reduction of the equity risk factor to 22 %, is quite substantial. On the other hand, the criteria for LTEI are unfortunately difficult to meet. It can be inferred from the preamble of the Delegated Act introducing the LTEI in 2019 that the latter was deliberate, out of fear of regulatory arbitrage. In hindsight, it appears that the dynamic of intention and interpretation by various (local regulators) has limited the success of facilitating further equity investments and financing of long-term sustainable growth. Moreover, as the examples of France and Germany (see box "Status Quo") are showing, the current implementation is contrary to the Union's goal to achieve a "level playing field".

Upcoming Solvency II review

With the Solvency II Review (discussed since 2020 and expected to be finalised in 2024) the regulator aims for the right interpretation of LTEI currently in discussion. The elephant in the room is whether the regulator achieves the goal to enlarge the scope of Long-Term Equity and ease the conditions for applications so as to help achieve European sustainability goals.

At the beginning of the original discussions around LTEI, insurers seemed quite bullish to implement the new "asset class", especially after the average holding period required was set at 5 years, instead of the 12 years originally proposed. The only remaining caveat seemed to be the "ring-fencing" requirement, i.e., the reference to separate management and prohibition of offsetting gains and other losses.

Key takeaways

- Since implementation, limited use of the Long-Term Equity (LTE) of Art. 171a seen in the European market.
- Conservative interpretation from local supervisors of the terms "managed separately" and "average holding period of 5 years".
- Ongoing review of the terms to ease interpretation and align definitions across Europe.
- We don't expect major changes to Article 171a itself.
- Linking LTE to sustainable equity investments can foster the path to the European sustainability goals, where Insurers play a major role in achieving these targets.

The wording of this requirement mirrors the "ring-fencing" condition in the context of the matching adjustment (MA). Since this specific measure is only applied in the UK and Spain, given their specific liability structure, there has remained great uncertainty in the market as to whether the application of the LTEI is also limited to countries applying the MA.

Interpretation with a focus on long-term investing

If we move away from the "ring-fencing" requirements and focus on the long-term aspects, what would be the goal of such a subset of investment, and the required assumptions to keep the capital charge prudent and avoid mere regulatory arbitrage?

When insurers focus on demonstrating that the ability and willingness to hold this subset of assets is given for at least 5 years, including stress scenarios, instead of focusing on ring-fencing, the LTEI becomes valuable. It should be sufficient to match the long-term investments with liabilities that have a duration of minimum 10 years. As long-term investors with a time horizon of 20 years and longer, this should be no problem.

Insurers could follow a four-step approach:

(I) Define a subset of assets, in this case private or listed equity.

(II) Show ability and willingness or intention to hold these assets for a longer term (standard procedure on the debt side with a buy & hold approach) given that liabilities have a long duration (especially in the life business).

(III) This subset is clearly defined and is managed "separately". (In the case of France, this is more easily done by the architecture of the local accounting framework of portfolios.).

(IV) Demonstrate that the average holding period exceeds 5 years and show the ability to hold these assets for the next 10 years, even under stress scenarios.

The above point might not be exhaustive, but to summarise it: insurance companies are long-term investors and have a proven track record of being able to hold assets on their balance sheets throughout different business cycles and even financial crises.

Way forward

We believe that Private Markets are here to stay. The industry made sure it understood private equity/debt as an investment class well over the last decade, especially as diversification is key. It might not seem to be the very best time to further expand investments in private markets now, but with the expected easing of the SII regulation another step towards making (private) equity investments more attractive is completed.

In fact, the use of the LTE regime combining both equity type 1 (listed) and equity type 2 (private equity) will enable insurers to benefit from greater equity intermodule diversification, even reducing the SCR of LTE from 22% to 16%.

Kim Rix
Insurance Specialist

Hadrien Sag
Insurance Specialist, Director

Teoman Kaplan
Actuary DAV

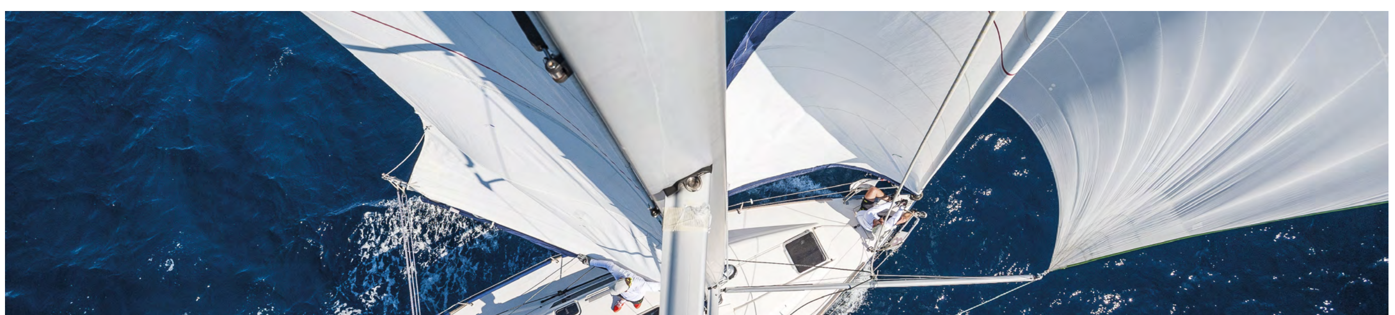
Dr. Florian Ueltzhöfer
Actuary DAV/IVS

One more thought to end with:

In the past crises, we have seen that neither government nor central banks were able to stimulate the real economy in the desired way. Private investments are needed, especially from insurance companies and pension funds, to stimulate and support growth in the real economy. Specifically with all the sustainability initiatives going on, insurers are a key stakeholder in financing the green transition in Europe. That's why introducing and revising qualifying criteria is very useful.

Another important point is the ability of insurers to invest for the long term, and to be able to hold these investments throughout different business and economic cycles. Nobody is better suited to support long-term investments than insurance companies and pension funds. Hence, giving insurance companies the opportunity to invest strategically in these assets for the long term is not only necessary, but some might argue mandatory.

Last but not least, we believe that long-term private investments in equity and debt are essential to finance the transition of companies, projects and infrastructure towards a sustainable future. All in all, change in regulation is a constant challenge to adapt to the new (economic) environments we face.



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