Didier Millerot
Head of Unit Insurance and Pensions
Directorate Financial Stability,
Financial Services and Capital Markets
Union
European Commission
Rue de Spa 2
1049 - Bruxelles

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AMICE Note on long-term equity investments

Dear Mr Millerot,

We appreciate the European Commission´s decision to introduce in the Delegated Regulation a new asset class for long-term holdings in equity investments of EEA companies. However, the insurance industry is facing operational challenges when implementing the LTEI (Long-Term Equity Investments) shock. The conditions required under Article 171a of the Delegated Regulation are impracticable in many respects and constitute a huge limitation to the recognition of the true features of equity long-term management and reduced risk.

We thank you for taking into consideration the points raised in this note, and should you or your staff wish any further information, we remain at your disposal.

Yours sincerely

Sarah Goddard
Secretary General

cc Justin Wray, EIOPA

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Executive Summary

The most inappropriate criterion to characterise long-term management and the one that can introduce the most volatility relates to the average holding period of 5 years:

Average holding period of 5 years is inappropriate

- Indeed, long-term management is characterised above all by the willingness (as demonstrated in the determination of target allocations) and the ability (as demonstrated by the control of the choice of investment and disinvestment dates without being constrained particularly to sell at a loss) to invest in shares for a very long time, which can be observed through the significant proportions held in the balance sheet over time.
- However, for many reasons, from the need to generate capital gains down-streamed in the profit and loss income statement, particularly on a regular basis, to the proper formation of prices on financial markets and the maintenance of optimal performance prospects, the insurer must be able to buy and sell quite commonly, and this will immediately affect any criterion based on the calculation of an average holding period, making this indicator ineffective.
- The average duration will depend on many parameters that cannot be factorised into one single value.

Average holding period of 5 years is volatile

- The definition of the holding period is not specified and can be interpreted in several ways. In the case of FIFO accounting, the lines sold will have a very significant impact on the holding period. In the extreme, in the case of a sale followed immediately by a buyback, economic exposure is unchanged, whereas the holding period can be very materially affected. If the average duration per line method is used, this duration indicator is sensitive both to sales transactions and also to purchases, which can generate volatility in the base of equities eligible for the reduced shock.

We recommend an ex ante criterion based on the insurer's ability to avoid a sale at a loss rather than an ex post assessment that is not necessarily representative of current policy and future capacity.

Next, the limitation of the reduced shock to equities backing technical provisions impedes undertakings to qualify equities backing own funds as long term although this is very much the case in practice. Own funds are a key factor of the balance sheet’s stability and instrumental in the long-term strategy of (re-) insurance companies.

We propose several remedies to these drawbacks. The main issue raised is a better appreciation of the undertakings’ ALM and risk appetite. The holding period should be more clearly and more practically defined and aligned with the overall spirit of the article.

Background

The 2018 review of Solvency II introduced a new Article 171a in the Delegated Regulation relating to the LTEI.

This new equity type was introduced to capture the reduced level of risks associated with long-term management of equity investments, in contrast with the previously implemented equity risk types. LTEI are subject to a capital charge of 22% while other equity investments (with the exception of infrastructure and strategic investments) incur a charge of 39% or 49% adjusted with the symmetric adjustment.

The inadequate capital charge associated with equities held with a long-term perspective has played a significant role in restricting European long-term investments hence entailing strong negative consequences on the economy, growth, employment and the financial markets. Hundreds of billions of euros are estimated to have been diverted from production, development and innovation while financial markets have been left deprived of major sources of stability and of countercyclical behaviours that invaluably enhance their functioning.

The loss of performance that an insufficient growth brings to Europe also translates into losses of investment returns to insurance undertakings. This is affecting the performance of insurance products, be they life or non-life, as well as limiting the own funds' performance of the insurance sector as a whole and the sources of the building of own funds in mutual insurance undertakings in particular.

The amendment to the Delegated Regulation with Article 171a came with a set of conditions for eligibility aiming at qualifying the long-term perspective of the management of the equity investments.

Operational Feedback: the eligibility criteria laid down are impractical

The criteria set by the new Article 171a that we find inappropriate are reviewed hereafter.

1. Criterion: Portfolio of assets assigned to best estimates of clearly identified obligations

We identified two issues when facing this condition of assignation to the best estimate of clearly identified obligations.

The first issue relates to the exclusion of own funds from the scope of LTEI assignation. This has no clear motivation. Own funds may represent a significant part of the balance sheet, especially for non-life insurers, and the application of the article is severely constraining. More importantly, own funds are long term by essence and instrumental in the long-term investment strategy of an undertaking. They often represent the archetypal liability item with the features to support LTEI, for instance typically in mutual entities. Tier 1 own funds strengthen the insurer's overall resilience to market volatility and its ability to act in a counter-cyclical manner, and may represent a major source of risk reduction and performance improvement.

Second, the identification of a sub-set of obligations may be largely artificial for undertakings operating with pooled liabilities.

2. Criterion: Separate management

The requirement to have clearly identified assets and liabilities that are managed separately and whose gains or losses cannot be diversified away through the balance sheet should not stand for a general requirement. While this criterion might reflect the dynamics of a certain type of insurance undertakings' balance sheets reflecting specific risk appetites, product designs, market features, legal requirements, it is not a valid criterion for those insurers not bound to undertake any segregation of their assets or liabilities (notably non-life insurers) and for which a key strategic ALM feature is optimisation of performance through optimised diversification.

Let us underline that diversification among assets and liabilities is a way to diversify risks in many dimensions: diversification of the different asset categories and types among the entire asset universe; diversification of all insurance liabilities under management; diversification over time (financial market behaviours, generations of contracts, subscriptions, premiums).

Finally, this requirement introduces "silent ring-fencing" in the balance sheet of undertakings willing to apply LTEI framework. This requirement severely reduces the scope of the new article. It impedes a large number of undertakings from implementing a reduced shock despite their willingness and ability to operate long-term investments. No segmentation is relevant towards own funds and the assets backing them in the presence of one single general asset pool, implying that assets are managed in the same way whether they are homothetically representing technical liabilities or own funds. Consequently, equity shares backing own funds should be eligible to LTEI reduced shock and able to meet any relevant criteria since own funds provide the longest horizon term for investments and are particularly illiquid, notably in mutual type entities.

3. Criterion: A part of technical provisions

The wording of Article 171a-1(d) stating that *the technical provisions within the portfolio of insurance or reinsurance obligations referred to in point (b) only represent a part of the total technical provisions of the insurance or reinsurance undertaking* is vague and not legitimate. While a limit of half the balance sheet is set in Recital 26, the lack of precision concerning the proportion of technical provisions that could be eligible to LTEI is likely to lead to inconsistent applications across Europe with various levels of acceptations for the proportion that may be eligible.

Above all, the limitation of the scope of technical provisions will prove artificial in many cases, notably where no ring fencing or segregations in the management of those liabilities exist. The amount of assets eligible to LTEI reduced shock should be assessed through the actual features of the ALM of the undertakings concerned. It should be based on an assessment of their risk appetite, ways of constructing their asset portfolio and managing their investments with regards the liabilities. **Where no segregations exist and all the equity portfolio is managed with a long-term approach, no sub-set should be delineated**.

Last, a broad amount of free surplus gives, de facto, more freedom to take risks and invest through economic cycles. It reduces the risk profile by enhancing countercyclical behaviour and long-term stance. Hence it will often be the case that equity investments backing own funds are managed with the most robust long-term strategies, and where no segregation is performed there should not be any sub-set exclusions of the LTEI delineation.

4. Criterion: Average holding period of five years

On a positive note, the possibility to assess the holding period based on an average determined across the equity portfolio rather than at individual security line level has been a major step forward towards featuring LTEI. It acknowledges that, depending of the nature of the investment vehicle and management actions types, long-term investment is not limited to buy-and-hold strategies at individual security lines level. To feature LTEI properly, the approach should rather be situated at portfolio level to capture in a holistic way the true underlying dynamics.

However, a requirement based on a fixed holding period has proven to be challenging from an operational standpoint. The way to define and compute the average may be subject to various interpretations. We find that the measure of an ex post assessment of the five-year holding period sets undue constraints. For instance, an undertaking may sell equity investments in order to recognise unrealised gains without questioning its investment strategy. Some room has been left for undertakings to allow them to apply a reduced shock for portfolios whose average holding period is less than five years, provided they do not sell any investment until this limit is reached. This last condition proves to be preclusive since it may be challenging for an asset manager to refrain from any rebalancing of his portfolio for several years.

An example we identified was that of an undertaking using FIFO accounting methods which may change drastically their average holding period after a single selling since the eldest shares are sold first.

Proposed Modifications

1. Taking into account own funds: two situations

The condition confining the assignment of LTEI to the coverage of best estimates as stated in Article 171a-1(b) should be amended and completed in order to accommodate the additional situation of insurance undertakings with LTEI backing own funds. **At the very least, free surplus investments should get that latitude.**

The current wording of Article 171a-1(b) should be maintained where segregations of assets or liabilities exist within an insurance undertaking's balance sheet. In case of segregated funds, each fund should be scrutinised with regards to its own characteristics and constraints to check whether it meets the conditions of eligibility to LTEI. Likewise, where own funds are managed separately from technical provisions, they form a fund that should be analysed against LTEI eligibility conditions.

For undertakings exercising ALM across the entire set of liabilities and assets as one pool on each side of the balance sheet, the analysis should be performed at this global level with no sub-set delineation. In this case, equity investments backing insurance liabilities as well as own funds should be perused for eligibility to the reduced equity shock against LTEI conditions at the global level.

2. Allowance for the diversity of ALM strategies

Undertakings managing their balance sheets at a global diversified level with pooled assets and pooled liabilities are taking advantage of optimisation effects that enhance risk diversification and management of risks where no specific requirement are impeding this core insurance ability. Therefore, Article 171a-1(c) and Article 171a-1(d) are not applicable to them.

For insurance undertakings where segregations of assets or liabilities exist (a feature that can have different sources like product design, law requirement, risk appetite and ALM choice) Article 171a-1(c) and 171a-1(d) are applicable.

3. Moving from an ex post average holding period to an ex ante capacity of holding

The current ex post assessment criterion is unduly challenging to comply with and would advantageously be assessed ex ante. Any ex post average duration will depend on many parameters that cannot be factorised into one single value.

The ex ante holding period is appreciated beforehand through the capacity of investors to effectively detain equity investments for a long time, and notably avoid any sale at a loss. It should be noted that an ex ante approach would be consistent with the other criterion set in the article paragraph (g) and (h).

On top of not being a good instrument to measure risk, any criterion based on an ex post average holding period will be a source of potential strong volatility.

We propose an amendment to this criterion as follows: ***"The average holding period may be appreciated through effective economic exposure as demonstrated in the prudential balance sheet track record over the last five years"***.

Undertakings would be required to demonstrate through their balance sheet track records the proportion of equity investments they effectively hold in their investments. **This formulation would present the advantage of operational simplicity and rely on the prudential balance sheet rather than on an ad-hoc volatile and unreliable indicator**.

However, in order to avoid artificial effects due to the instantaneous snapshot of the balance sheet (e.g. an undertaking made a movement on the 31/12/N and reverses it on the 01/01/N+1), an undertaking should use its strategic asset allocation in lieu of the effective exposure when it is not deemed to reflect the long-term strategy of the undertaking, provided it complies with a liquidity test (see below).

4. Improving the assessment of forced sales

Article 171a-1(g) should establish how to demonstrate the ability to avoid forced sales. We suggest to resort to the liquidity test proposed by AMICE for LTGA review 2020 (see Appendix B) based on a 10% risk level for a duration of five years.

Undertakings should demonstrate on the base of the liquidity test their capacity to avoid a 39% or 49% loss and to hold their equity investments for better market conditions at least for five years in order to wait.

The liquidity test has to be applied to the strategic asset allocation, when the undertaking anticipates a deviation between the observed past allocations and future allocations. This allows the alignment of the amount of investments eligible to LTEI-reduced capital charge in line with the effective anticipated risk profile of the company.

Appendix A – Article 171a Solvency II Delegated Regulation

Article 171a

Long-term equity investments

1. For the purpose of this Regulation, a sub-set of equity investments may be treated as long-term equity investments if the insurance or reinsurance undertaking demonstrates, to the satisfaction of the supervisory authority, that all of the following conditions are met:

(a) the sub-set of equity investments as well as the holding period of each equity investment within the sub-set are clearly identified;

(b) the sub-set of equity investment is included within a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, and the undertaking maintains that assignment over the lifetime of the obligations;

(c) the portfolio of insurance or reinsurance obligations, and the assigned portfolio of assets referred to in point (b) are identified, managed and organised separately from the other activities of the undertaking, and the assigned portfolio of assets cannot be used to cover losses arising from other activities of the undertaking;

(d) the technical provisions within the portfolio of insurance or reinsurance obligations referred to in point (b) only represent a part of the total technical provisions of the insurance or reinsurance undertaking;

(e) the average holding period of equity investments in the sub-set exceeds 5 years, or where the average holding period of the sub-set is lower than 5 years, the insurance or reinsurance undertaking does not sell any equity investments within the sub-set until the average holding period exceeds 5 years;

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

(g) the solvency and liquidity position of the insurance or reinsurance undertaking, 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 avoid forced sales of each equity investments within the sub-set for at least 10 years;

(h) the risk management, asset-liability management and investment policies of the insurance or reinsurance undertaking reflects the undertaking's intention to hold the sub-set of equity investments for a period that is compatible with the requirement of point (e) and its ability to meet the requirement of point (g).

2. Where equities are held within collective investment undertakings or within alternative investment funds referred to in points (a) to (d) of Article 168(6), the conditions set out in paragraph 1 of this Article may be assessed at the level of the funds and not of the underlying assets held within those funds.

3. Insurance or reinsurance undertakings that treat a sub-set of equity investments as long-term equity investments in accordance with paragraph 1 shall not revert back to an approach that does not include long-term equity investments. Where an insurance or reinsurance undertaking that treats a sub-set of equity investments as long-term equity investments is no longer able to comply with the conditions set out in paragraph 1, it shall immediately inform the supervisory authority and shall cease to apply Article 169(1)(b), (2)(b), (3)(b) and (4)(b) to any of its equity investments for a period of 36 months.';

Appendix B – Liquidity test

The “liquidity test” aims at evaluating potential situations of forced sales and should rely on the following:

- It should encompass the assets and liabilities on the economic balance sheet and any collateral requirements having an impact on the liquidity position;
- It should follow the 1-in-200-year scenario. The scenario should focus on the impact on the cash position (or liquidity position). The insurer will assess whether assets are forced to be sold with materialised unrealised losses in order to recover from liquidity gap position, i.e. a negative cash position. Any existing other measures should first be considered, such as existing credit lines, repos, etc;
- An insurer has adequate liquidity risk management and liquidity stress testing;
- If DVA is applied, the liquidity test to be performed would be an holistic scenario calibrated on a 99.5% level.
- The capital requirements within Solvency II focus on the impact on the available own funds. From a “going concern” point of view, an economic loss is not similar to a realised loss;
- Within fixed income securities (with a maturity), the passing of time will automatically move the economic value towards the maturity amount/redemption value. Any economic loss will recycle as an economic gain and vice versa;
- The only risk to this automatic cycle is the counterparty default and/or the requirement to sell the asset in order to be able to pay any liability;
- The liquidity test is based on an instantaneous stress and a projection of the cash flows over the following 3 to 5 years. These cash flows will take into consideration the instantaneous stresses applied.

The stress scenarios should be assessed regarding their impact on the cash position of the insurer over a 3 to 5-year horizon after the recognition of the scenario.

Market risks

Equity, interest rates, property and currency risks are assessed through their impacts on collateral requirements. Spread shocks are translated into the impact on default and fundamental spreads.

Life risks

Mortality, longevity, morbidity, revision and expenses risks should be translated into the impact on the appropriate time horizon of the liquidity test, if material. For catastrophe and lapse risks, the liquidity impact is assumed to be equivalent to the capital requirement. The mass lapse shock is first applied, after which the other scenarios are applied.

Non-life risks

Premium and reserve risks should be translated into the impact on the appropriate time horizon of the liquidity test, if material. For catastrophe and lapse risks the liquidity impact is assumed to be equivalent to the capital requirement. The lapse scenario is applied initially, followed by the others.

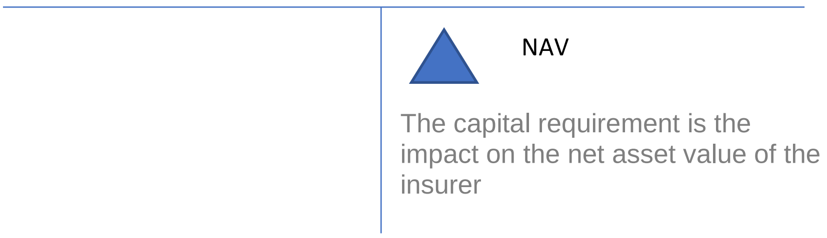
Other risks

For default, operational and intangible risks, the liquidity impact is assumed to be equivalent to the capital requirement.

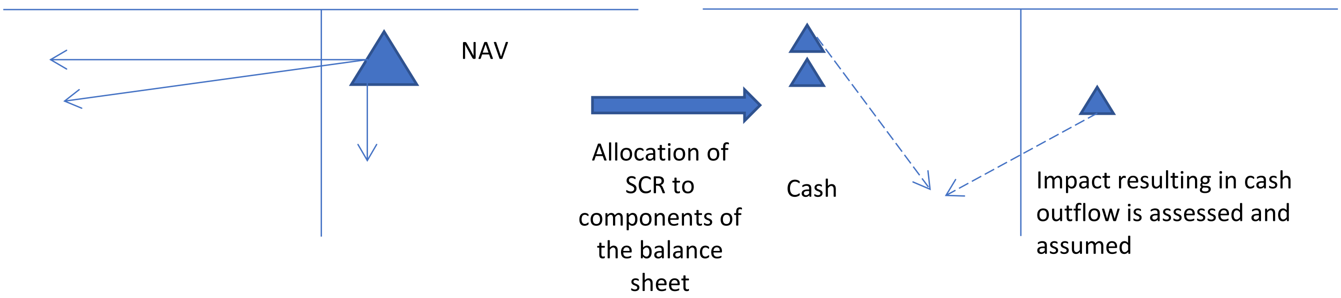
Enacting the liquidity risk

The liquidity test is a three-step process:

In the first step, the scenarios required by the standard formula or the (partial) internal model are applied:



In the second step, the SCR is allocated to its underlying causes and the impact on cash position is assessed.



In the third step, the liquidity needs are assessed.

Cash and cash equivalents	
Opening Balance	
Impact instantaneous scenarios on cash position	(-)
Opening Balance after the impact of the scenarios	A
Expected cash flows after impact scenarios year 1	(+/-)
Closing Balance (end period)	B
Expected cash flows after impact scenarios subsequent years	(+/-)
Closing Balance (end period)	B’

If A is negative, the insurer must demonstrate that the negative cash position can be recovered without the need to sell any assets which are backing the insurance liabilities (for example, using recognised credit lines, repos, secured lending or other arrangements).

If B is negative, the insurer must demonstrate that the expected negative cash position can be recovered without the need to sell any assets which are backing the insurance liabilities (for example, raising premiums).

If A and B’ are positive, or the insurer is able to recover from a negative position without the requirement to sell assets backing the insurance liabilities, the test is deemed to be passed in full. The assessment of the cash flows is done over the appropriate time horizon.