Position Paper

Insurance Europe comments on FSB evaluation of effects of financial regulatory reforms on infrastructure finance

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Introduction

Insurance Europe welcomes the opportunity to comment on the Financial Stability Board's consultative document on the evaluation of the effects of financial regulatory reforms on infrastructure finance.

It appreciates the importance and relevance of policymakers assessing the impact of their work on overarching growth and stability objectives, with a view to taking swift action to address any unintended consequences.

The FSB paper adopts an *ex-post* approach to assessing the impact of financial regulatory proposals. However, such an approach allows damage to be done before any remedial action is taken. This is not acceptable given the potential negative impact on consumers, economic growth and financial stability. Insurance Europe therefore reiterates the importance of policymakers taking a strong *ex-ante* assessment approach that considers the potential and likely detrimental impacts of regulatory proposals during their development and before finalisation. A thorough and robust *ex-ante* approach, focused on the same objectives of avoiding the hampering of growth and financial stability, is key. Together with an *ex-post* assessment, this should lead to the avoidance or minimisation of unintended consequences.[1]

General comments specific to the insurance sector

With respect to the current consultative document, Insurance Europe notes that most of the analysis is focused on the banking sector and banking regulatory provisions. However, the insurance sector is one of the largest investors in international capital markets.

[1] Please refer to Insurance Europe's comments on the FSB framework for assessing financial regulatory reforms (here)

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Insurers' long-term liabilities, together with their commitments to policyholders, require the matching of liabilities to suitable long-term assets, such as infrastructure. Interest by insurers in the infrastructure asset class has significantly increased in recent years, and therefore the regulatory provisions around such investments have become increasingly relevant.

Insurance Europe therefore focuses its comments on sections of the FSB paper that are of direct relevance to the insurance sector, from the perspective of insurers investing in long-term assets in general, and infrastructure in particular. Specifically:

- The interest of the European insurance industry in infrastructure assets has significantly increased in recent years. This supports the FSB observation of the increased diversity of providers of infrastructure finance.

- Prudential regulation can represent a significant investment barrier if regulations are not appropriately designed and calibrated. The European insurance industry welcomed the recent changes to Solvency II, which are referenced in the FSB paper. A prudential treatment that is better aligned to true risks creates scope for additional investments.

The Solvency II prudential framework for insurers requires them to hold capital to cover the risks that they are taking when making investments. While further improvements are needed to align capital requirements to actual risks and avoid barriers to long-term investment, important improvements have been made over the last two years in the area of infrastructure:

- First, infrastructure was identified as a separate asset in Solvency II. Before, it was looked at as any other corporate debt/equity, despite the fact that the risk characteristics of infrastructure are different.
- Second, more tailored capital requirements have been set for infrastructure. Before, the framework assumed that insurers act like traders when investing in this asset class and they are fully exposed to (a theoretical) market volatility. The new approach recognises, at least to some extent, that insurers buy with a long-term perspective and their exposure is to credit/default risk, not to market volatility risk.

- While more tailored capital requirements for qualifying infrastructure assets in Solvency II were very much needed and were welcomed by the industry, it has to be noted that the necessary work for assessing whether a particular infrastructure asset is "qualifying" for the tailored prudential treatment is often unnecessarily extensive and resource-intensive.

This comes as a result of an extensive set of criteria, often of subjective nature and judgement, which requires significant operational effort. In some cases, the "benefit" in terms of marginal reductions in capital requirements does not justify the "cost" of assessing qualification. One way to address this challenge and achieve a better balance would be to review the qualifying criteria, with the intention of simplifying them and making them more operational.

- A consistent accounting treatment for both assets and liabilities is key to appropriately measuring and supporting insurers' long-term business model and investments. The European insurance industry welcomed the alignment between the effective date of IFRS 9 (Financial instruments) and IFRS 17 (Insurance contracts) for insurers, which is mentioned in the FSB paper. However, the ban on recycling for equity instruments accounted for at fair value through other comprehensive income (FVOCI) in IFRS 9 still remains a significant concern and needs to be addressed to remove the accounting disadvantage for this type of equity financing in long-term projects because it leads to misleading performance measurement for insurance products involving long-term equity investment and creates unnecessary disincentives for equity investment (including investment in infrastructure assets).

- The limited supply of suitable infrastructure assets remains a key concern for the European insurance industry and a key challenge to more investment.

Insurers need a credible pipeline of attractive infrastructure assets in which they can invest. The European insurance industry is very much committed to investing more in infrastructure, and a number of companies have publicly indicated that they aim to invest up to 10% of their portfolio in this asset class. Unfortunately, there is a very limited supply of such assets today, with a lot of competition for existing projects.

Governments should therefore support the creation of infrastructure projects, that are suitable for institutional investors. The key characteristics of such projects should include:
- long maturities
- both equity and debt structures
- predictable cashflows
- investment grade projects, to match risk-aversion benchmarks
- public support by multilateral development banks, aimed at fostering the attractiveness of projects where needed and thus crowding in private investment.

However, the involvement of multilateral development banks should not lead to the crowding-out of private investments. Multilateral development banks should only engage in projects where there is no funding available through other sources (eg banks, insurers or pension funds).

Specific comments on the most relevant questions in the consultative document

IF trends

Question 4:
Search for yield: How important has the global search for yield been as a determinant of the growth in IF in recent years? Has search for yield behaviour been more apparent in specific sectors or regions?

Infrastructure is an attractive asset class for insurers for a number of reasons, including: 1) bringing portfolio diversification, 2) offering additional yield, which is very important especially in the current low interest rate environment, and 3) the ability of infrastructure to match the investment needs generated by insurers' long-term liabilities and obligations.

The search for yield has not been the only driver of insurers' increased investments in infrastructure, however it has played a significant role. In fact, the search for long-term investments and attractive yields/returns is a duty that insurers have towards policyholders.

Financial regulations

Question 6:
Regulation vs other factors: How do the financial reforms rank relative to other factors (e.g. macroeconomic and financial conditions, political risks, institutional impediments) in terms of their influence on IF?

Political risk and legal certainty and protection for infrastructure investments and investors are significant factors impacting insurers' decision-making, not least due to the fact that infrastructure assets often require very long-term commitments (10, 20 or 30 years).

Question 7:
Relevant reforms: Are Basel III and OTC derivatives market reforms the most relevant G20 reforms for IF? Which other reforms may also be relevant for the purposes of the evaluation? Please elaborate.

Please see the observations about "qualifying" infrastructure in the general comments section and the answer to Q16 below.

Question 16:
Effects of other reforms: G20 reforms that are at an earlier implementation stage, as well as national and regional regulations that apply to insurers and pension funds, have only been examined qualitatively. For these regulations, is there further relevant information about their impact on IF that should be considered by this evaluation?

Insurance Europe highlights the following areas that deserve more consideration:

- **Financial reporting standards (IFRS 17 (Insurance contracts) and IFRS 9 (Financial instruments)*)***

An aligned and consistent accounting treatment for both insurance assets and liabilities is necessary to support insurers' long-term business model and investments.

- While the alignment between the effective date of IFRS 9 and IFRS 17 for insurers was welcomed, the ban on equity recycling remains to be addressed. Insurance Europe continues to strongly support the reintroduction of recycling for equities measured at FVOCI in IFRS 9 as it is the only way to ensure the financial performance of long-term investors is correctly reflected in the profit and loss account.
- Together with the reintroduction of equity recycling, Insurance Europe supports the introduction of an impairment model for FVOCI.
- The necessary fix to IFRS 9 should be implemented before insurers are required to apply both IFRS 9 and IFRS 17 as of 1 January 2021. This could be done through a targeted narrow-scope amendment at IASB level, without waiting for the outcome of a potential future IFRS 9 post-implementation review.

- **Prudential regulation (Solvency II, ICS) — design and calibration**

There are two key elements of a prudential regulation that can have an impact on the investment behaviour of insurers, namely 1) calibration of capital requirements and 2) valuation of assets/liabilities. Both represented challenging and difficult discussions in Solvency II and, although not within the scope of this paper, these issues appear to be similarly challenging in the development of the global Insurance Capital Standard (ICS). Getting the calibration of capital requirements and the valuation right is not easy, but it is worth the effort. If these are wrongly designed, a combination of unnecessary bad outcomes can happen: capital is wasted, insurers are pushed away from traditional long-term business, costs for consumers and business can be higher, the industry capacity for long-term investment decreases and insurers are pushed from being natural countercyclical investors to procyclical investors. International standard-setting bodies should therefore assess the extent to which their standards are adequately calibrated to the particular characteristics of long-term investment in general, and infrastructure in particular.

Specifically:

1. **Capital requirements**: if these are calibrated based on the assumption that insurers act like traders and are always and fully exposed to the market prices of assets, then they will be extremely high and create disincentives for insurers to invest or insurers will require higher yield to invest.

In the specific area of infrastructure, the industry welcomed the recent work aimed at better aligning the capital requirements of infrastructure assets to the real risks to which insurers are exposed. However, the current capital requirements remain high and still include unnecessarily conservative assumptions on exposure to forced sales of assets. Such issues need more discussion and investigation in the upcoming Solvency II review.

2. **Valuation of insurers' assets and liabilities balance sheet**: in the insurance case, asset/liability matching is key. Therefore, a market valuation of assets can only work if the valuation of liabilities reflects the yield earned on assets matching those liabilities. Where cash flows of assets and liabilities are matched but discount rates for asset and liability cash flows are different, the differences in discount rates create a valuation mismatch between assets and liabilities and, in periods of market stress, this mismatch amplifies and creates artificial balance sheet volatility. This type of volatility is referred to as artificial because it is induced by valuation and does not stem from or exaggerate any real asset/liability or cashflow mismatch.

As a general comment, Insurance Europe supports the use of market values for the valuation of invested assets — but only if the liability measurement is able to recognise the long-term nature of the business and therefore can, where it is an appropriate reflection of product design, ALM or other risk management activities, reduce or eliminate the own funds' exposure to market value movements.

Insurance Europe believes that any work aimed at investigating if/how regulation can impact long-term investment should consider two key elements:

1. The methodologies for the valuation of insurers' assets and liabilities, which, if not appropriately designed, can create significant artificial balance sheet volatility that insurers will find difficult to cope with, especially in the case of long-term illiquid assets.
2. The methodologies for the calibration of capital requirements, which should ensure capital requirements avoid treating insurers like traders and thus exaggerating the measurement of market risk, particularly for long-term investments.

Insurance Europe encourages the FSB to take these issues into account in its upcoming work, including in the work for the Japan G-20 Presidency.

Additional considerations

Question 17: **Other issues:** Are there any other issues or relevant factors that should be considered as part of the evaluation?

Insurance Europe would encourage stronger statements from the FSB in its conclusions relating to the need for international standard-setting bodies — when designing new standards or reviewing existing standards — to have regard to the G20's commitments to support growth and the role of infrastructure finance in this respect.

In particular, Insurance Europe suggests that the FSB's statement that its conclusion *"does not preclude international standard-setting bodies from continuing to assess the extent to which their standards are adequately calibrated to the particular characteristics and risks of IF"* should go further. Specifically, the FSB should make more assertive statements about the need for standard-setting bodies — such as the IAIS in its development of the ICS — to take this into account.

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