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The Importance of the Insurance sector in European Equity and Credit Markets

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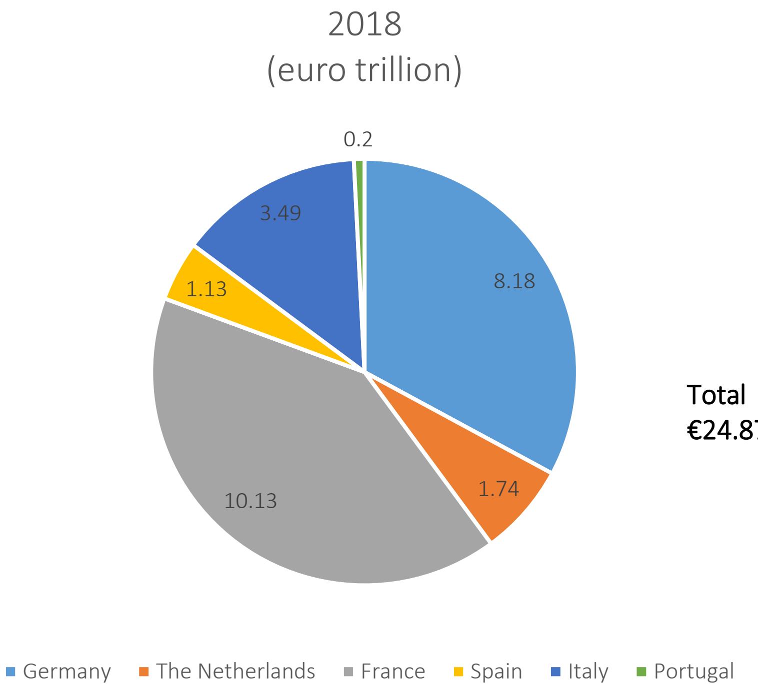
Key Message

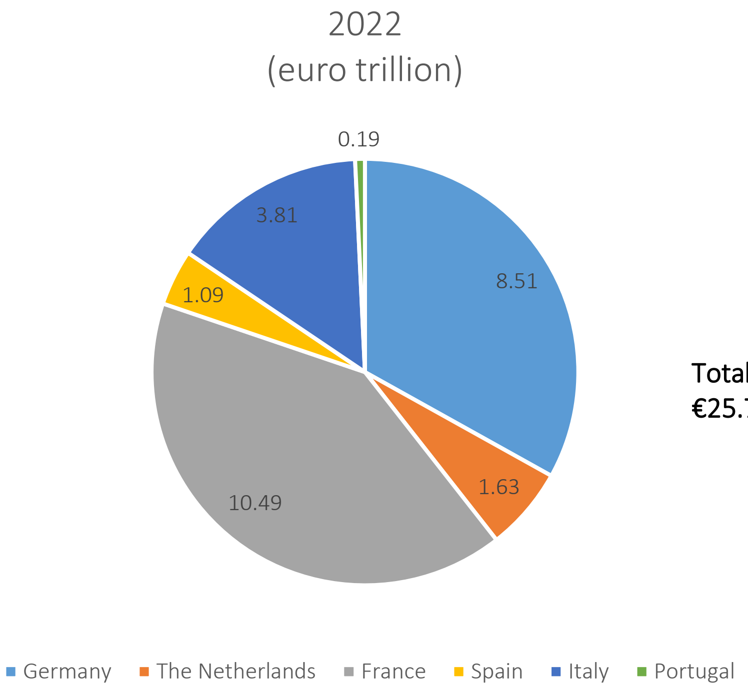
- *Investors prefer opaque equity investments to transparent equity investments.*
- *They tend to neglect liquidity aspects.*
- *Regulation drive this attitude e.g. Solvency II*
- *We have to break this norm in order to achieve a commonsense of risk and asset management*

Content

Total Investment by selected European Countries



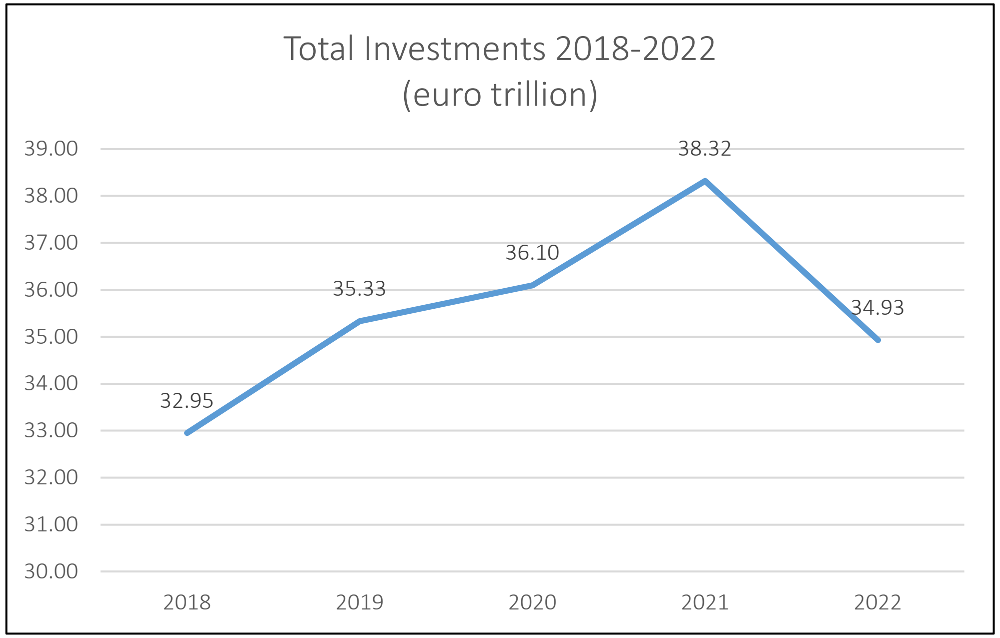
Total
€24.87 trillion



Total
€25.72 trillion

Source: EIOPA Insurance Statistics

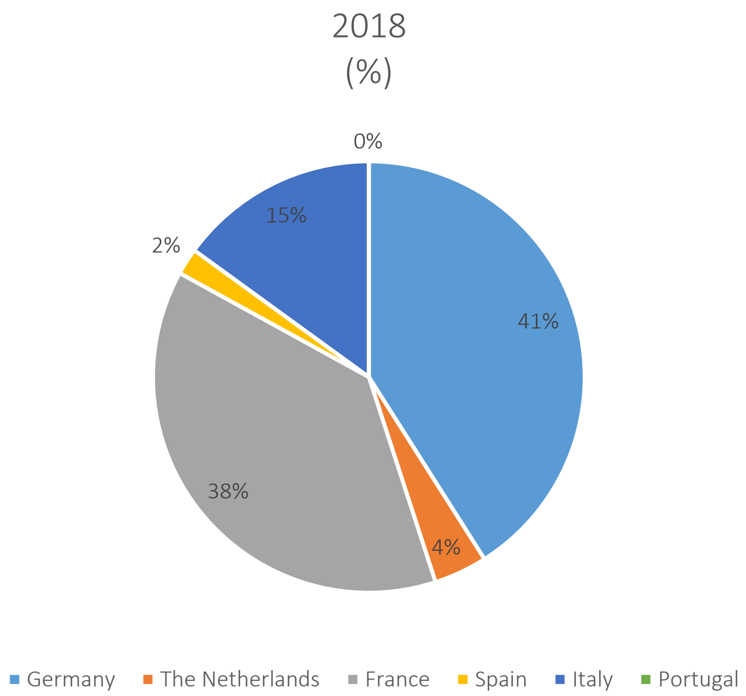
Total Investments made by European Insurance companies

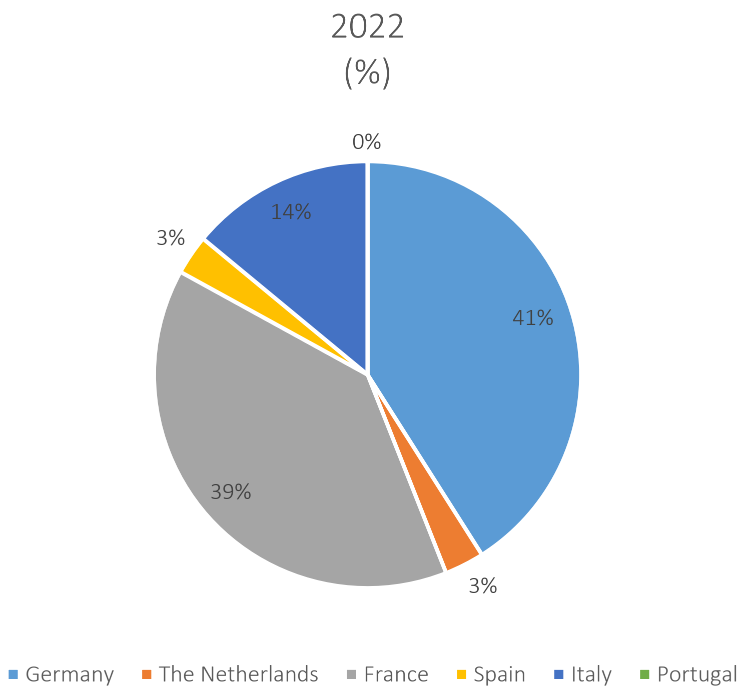


Investment Type:
Government Bonds
Corporate Bonds
Equity
Collective Investment Undertaking
Structured notes
Collateralised securities
Cash and deposits
Mortgages and loans
Property
Other Investments

Source: EIOPA Insurance Statistics

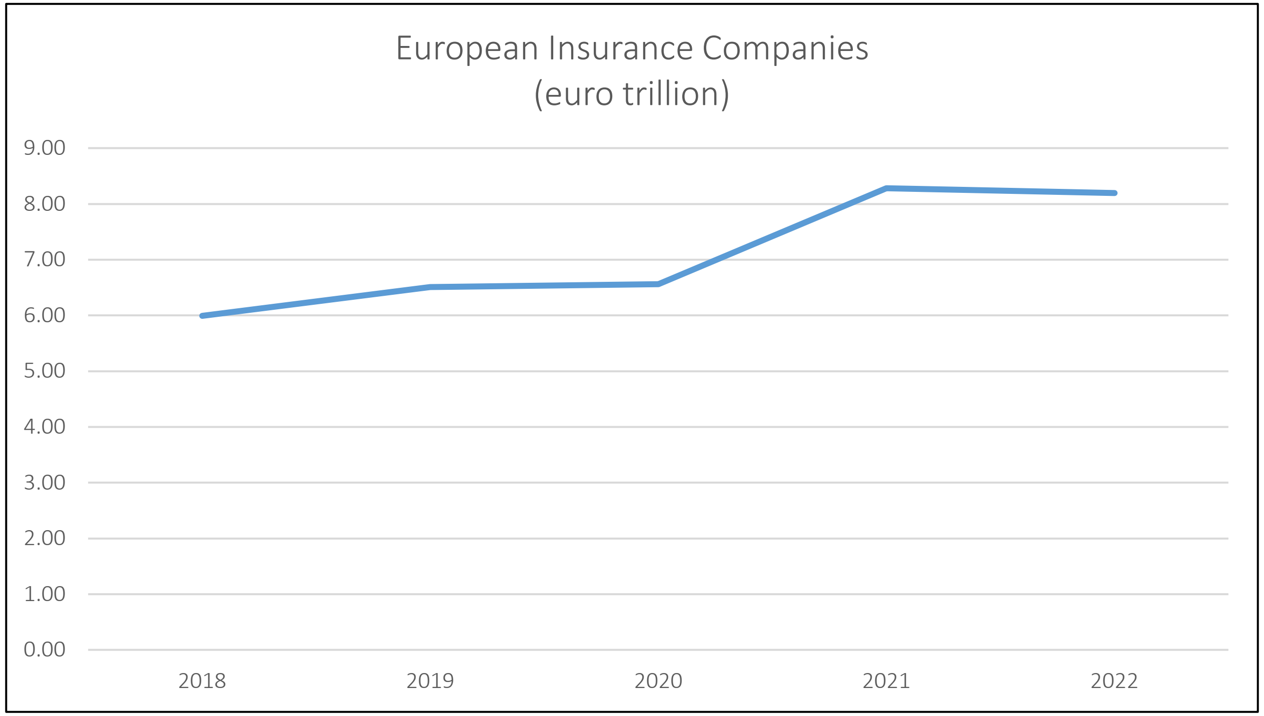
Equity Investments of selected European countries





Source: EIOPA Insurance Statistics

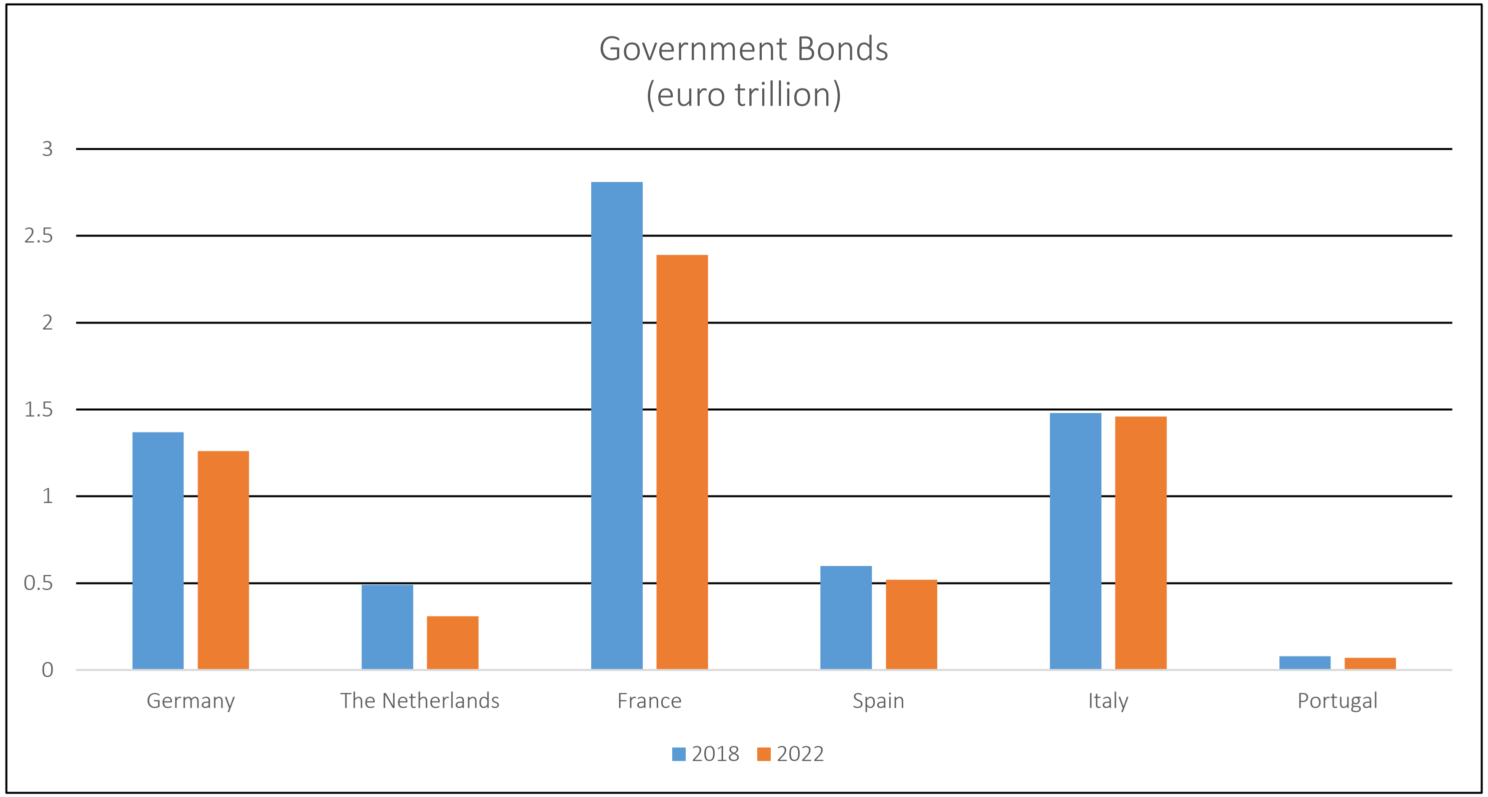
Equity Investments made by European Insurance Companies



Source: EIOPA Insurance Statistics

Credit Investments made by Insurance companies of selected European countries

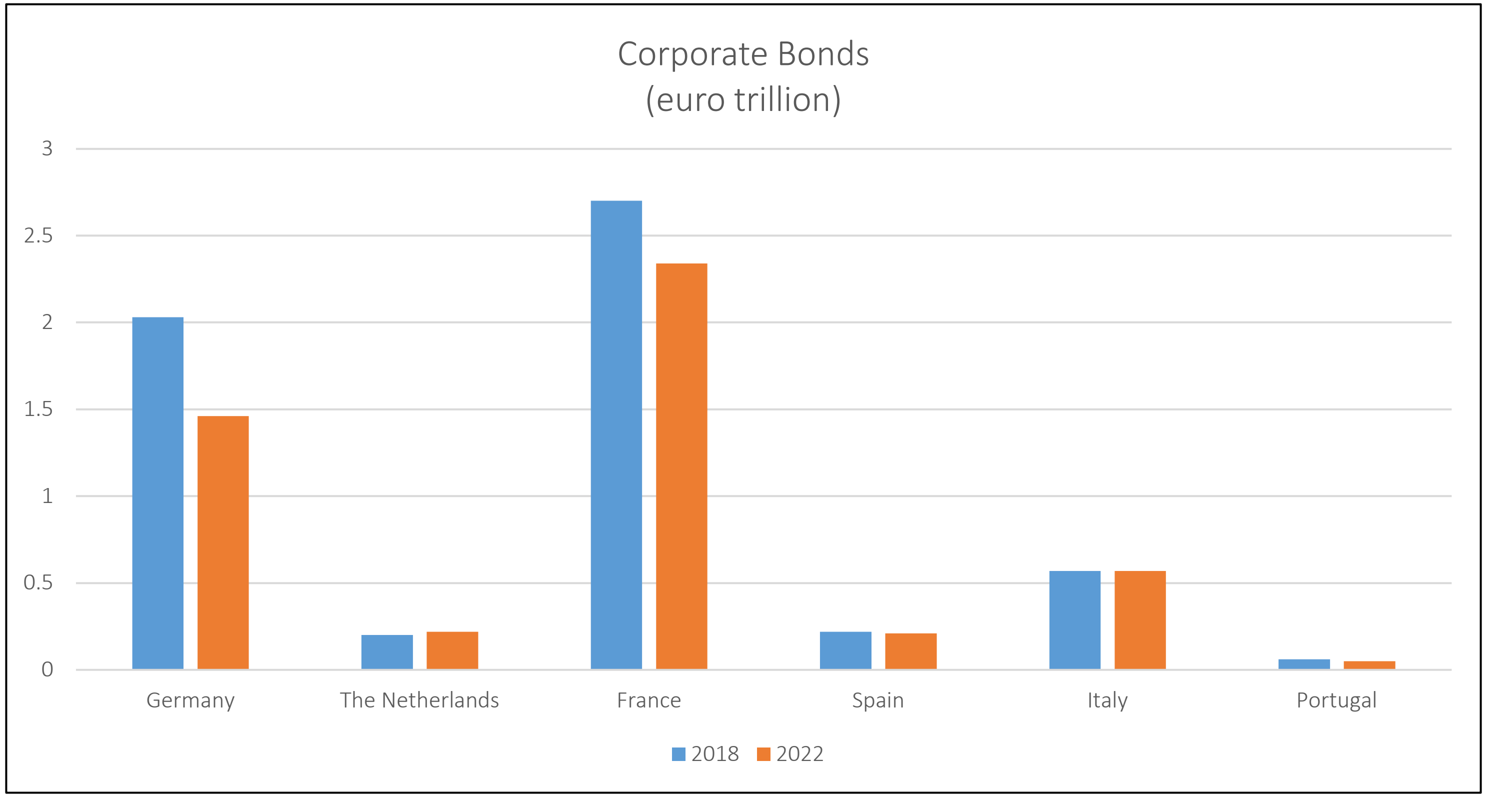
Government Bonds:



Source: EIOPA Insurance Statistics

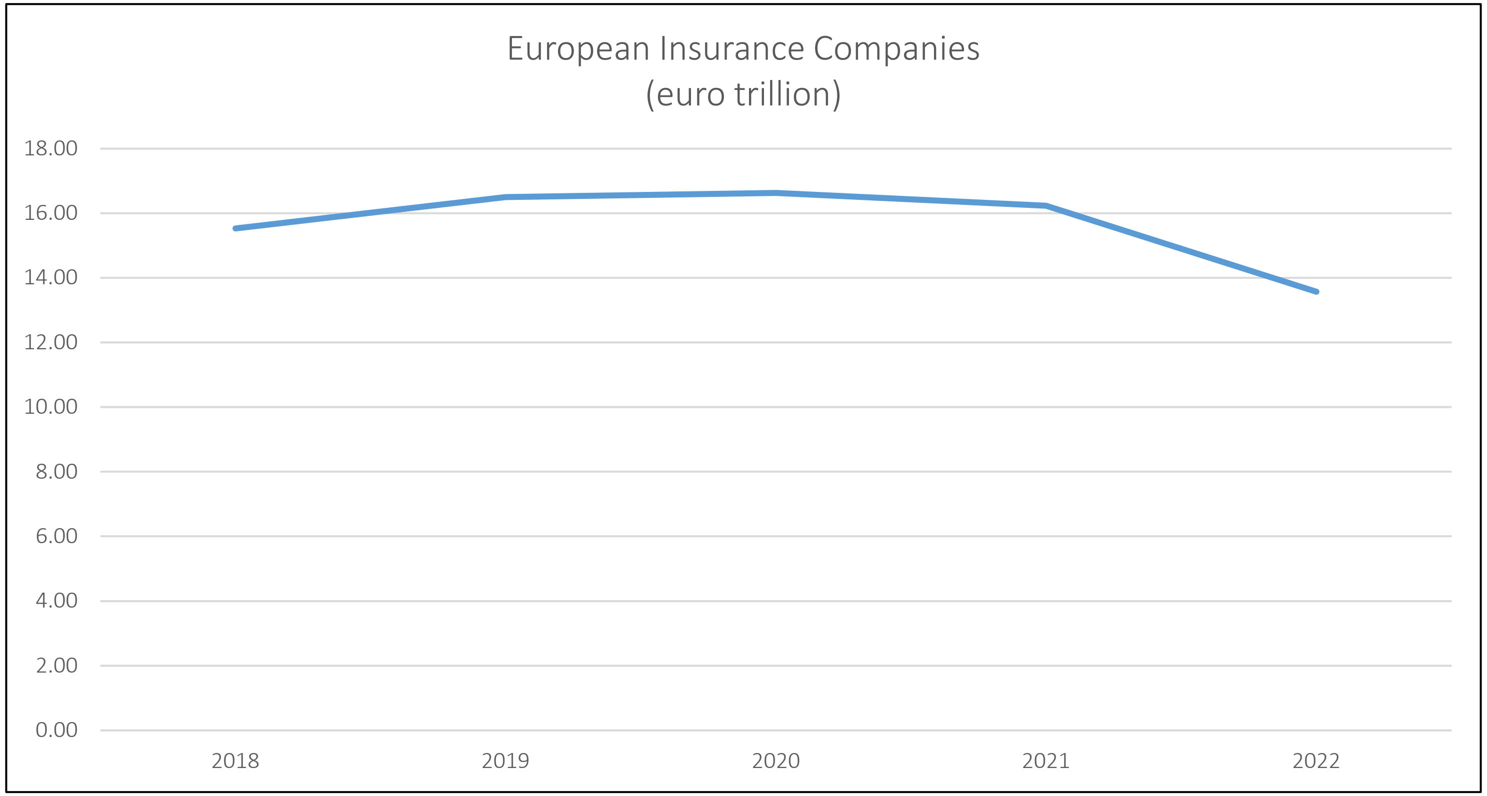
Credit Investments made by Insurance companies of selected European countries

Corporate Bonds:



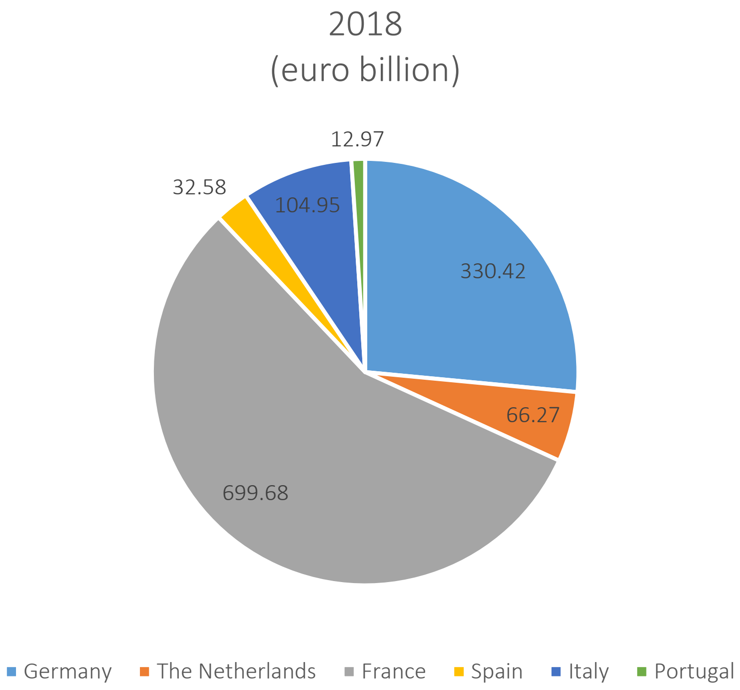
Source: EIOPA Insurance Statistics

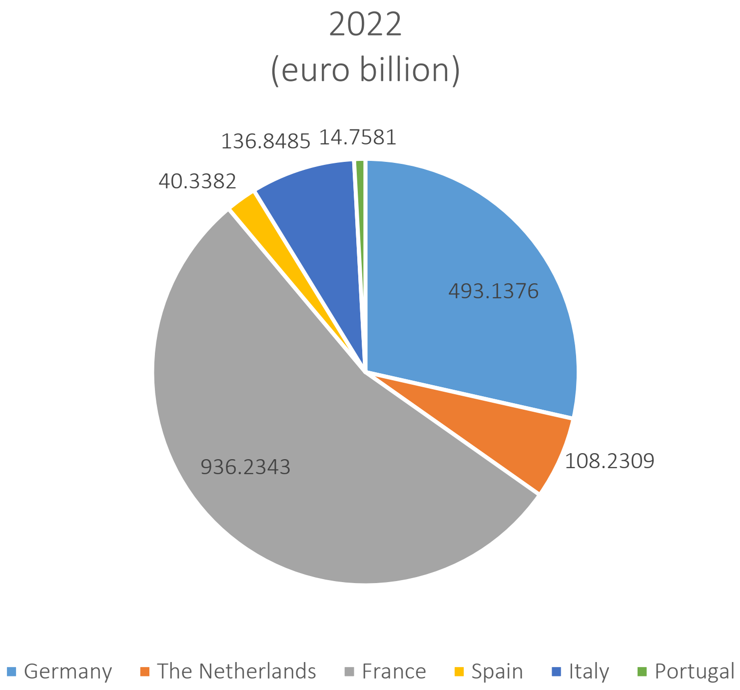
Credit Investments made by European Insurance companies: Total of Government & Corporate Bonds



Source: EIOPA Insurance Statistics

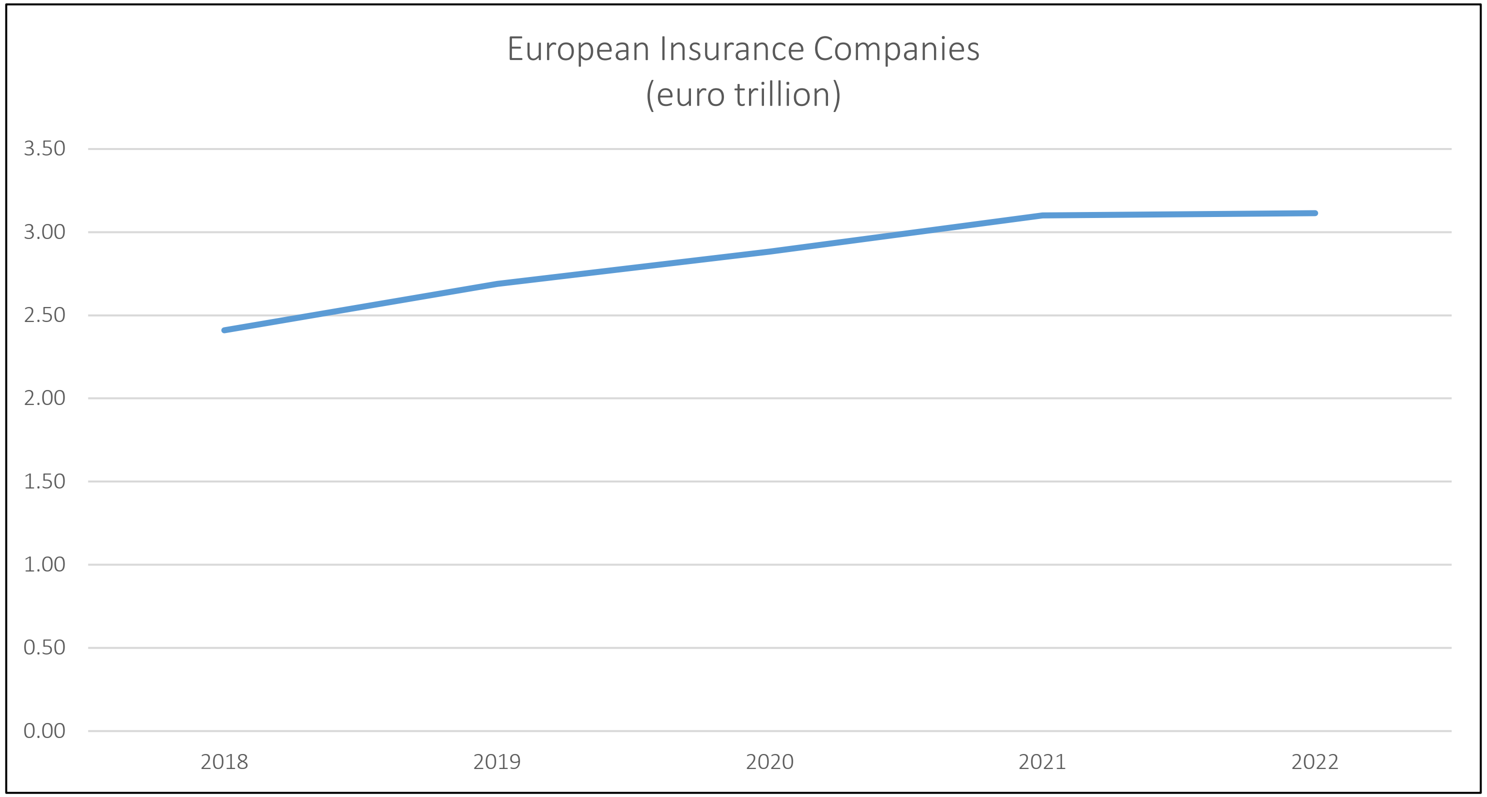
Real Estate Exposure by insurance companies of selected European countries





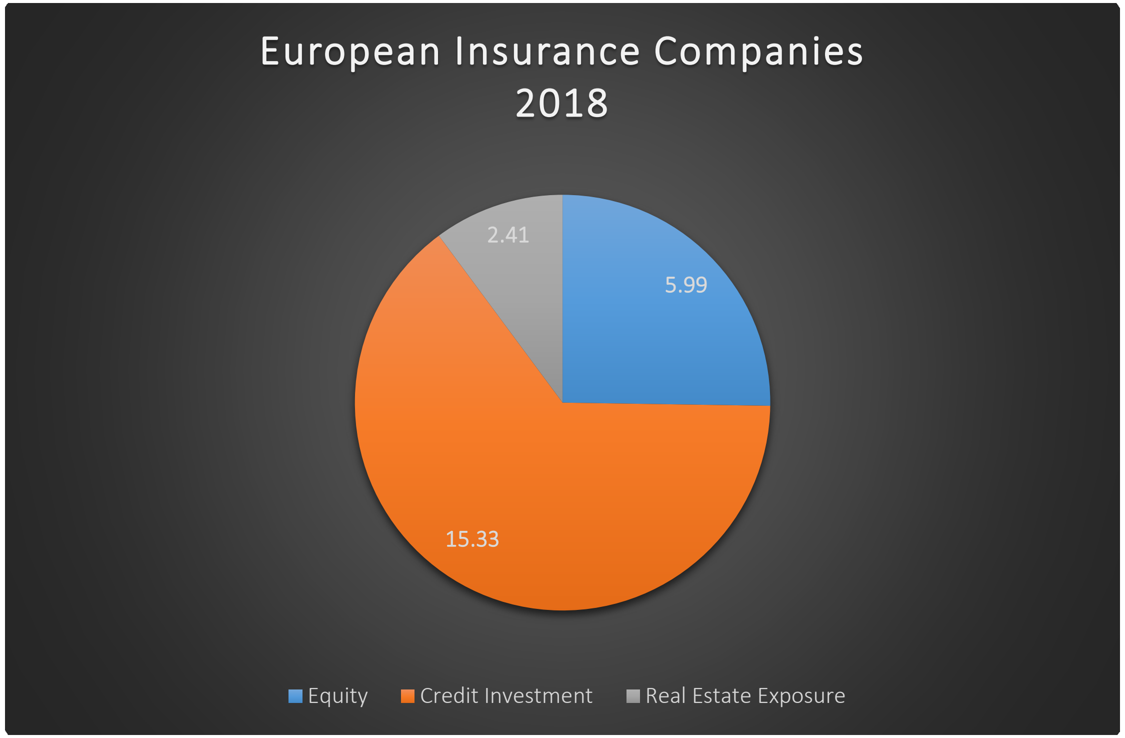
Source: EIOPA Insurance Statistics

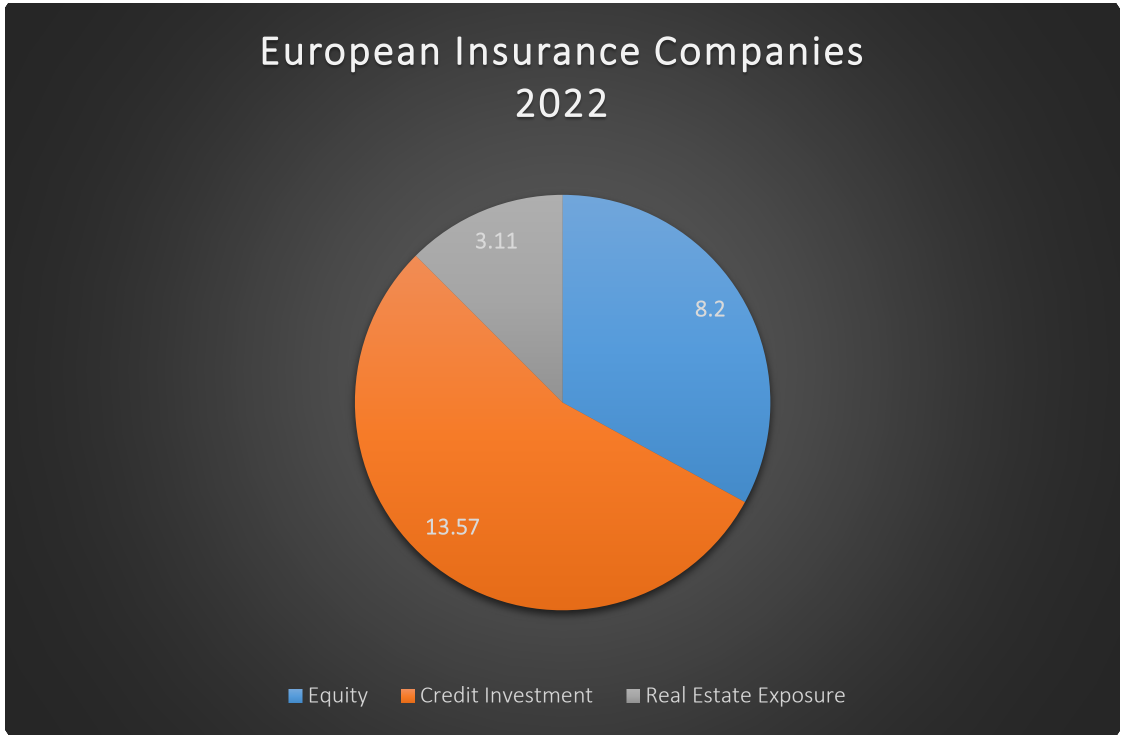
Real Estate Exposure by European Insurance companies



Source: EIOPA Insurance Statistics

Composition of Equity, Credit Investment and Real Estate Exposure





Source: EIOPA Insurance Statistics

Why are insurance companies reluctant of equities?

First reason: National accounting principles. Price volatility is seen as a sign of risk. If market prices are below book value at the 31.12. of each year, write-downs might affect the result.

Insurers prefer either bonds booked at book value or non listed equities.

➔they prefer personal valuation judgment and illiquidity to liquid pricing techniques

Second reason: Solvency II. All assets are booked at fair value but the capital charge differs according to the asset class of each asset. For equities it is 35% without the possibility closing down the duration gap. For interest rate risk instruments closing the duration gap it can go down well below 10%. Non-listed participations also are favoured in SII: only 22% capital charge.

Liquidity Risk – Unlisted Equity

Unlisted equity has a higher liquidity risk compared to listed equity due to lack of secondary markets and pricing difficulties.

➔ An advantage unlisted equity enjoys is its smaller volatility compared to listed equity.

Liquidity of equity investment differs depending on the participation:

For example – for listed equity the larger the ownership stake – the harder it becomes to exit the investment by selling the stake in public markets without price impact.

For private equity, a larger ownership can make it easier to exit such an investment.

Liquidity Risk – Unlisted Equity

Private Equity investment exhibit higher market and funding liquidity risk to public equity, which lead to higher expected returns of private compared to public equity.

➔ The existence of the PE liquidity premium becomes an investment rationale for institutional investors for whom liquidity constraints are unlikely to be a problem even in bad times.

Private Equity – European Private Equity Trends 2017-2022

European Private Equity experienced a downtrend in the second half of 2022. Both the deal volume and deal value remained below pre-pandemic level in this period.

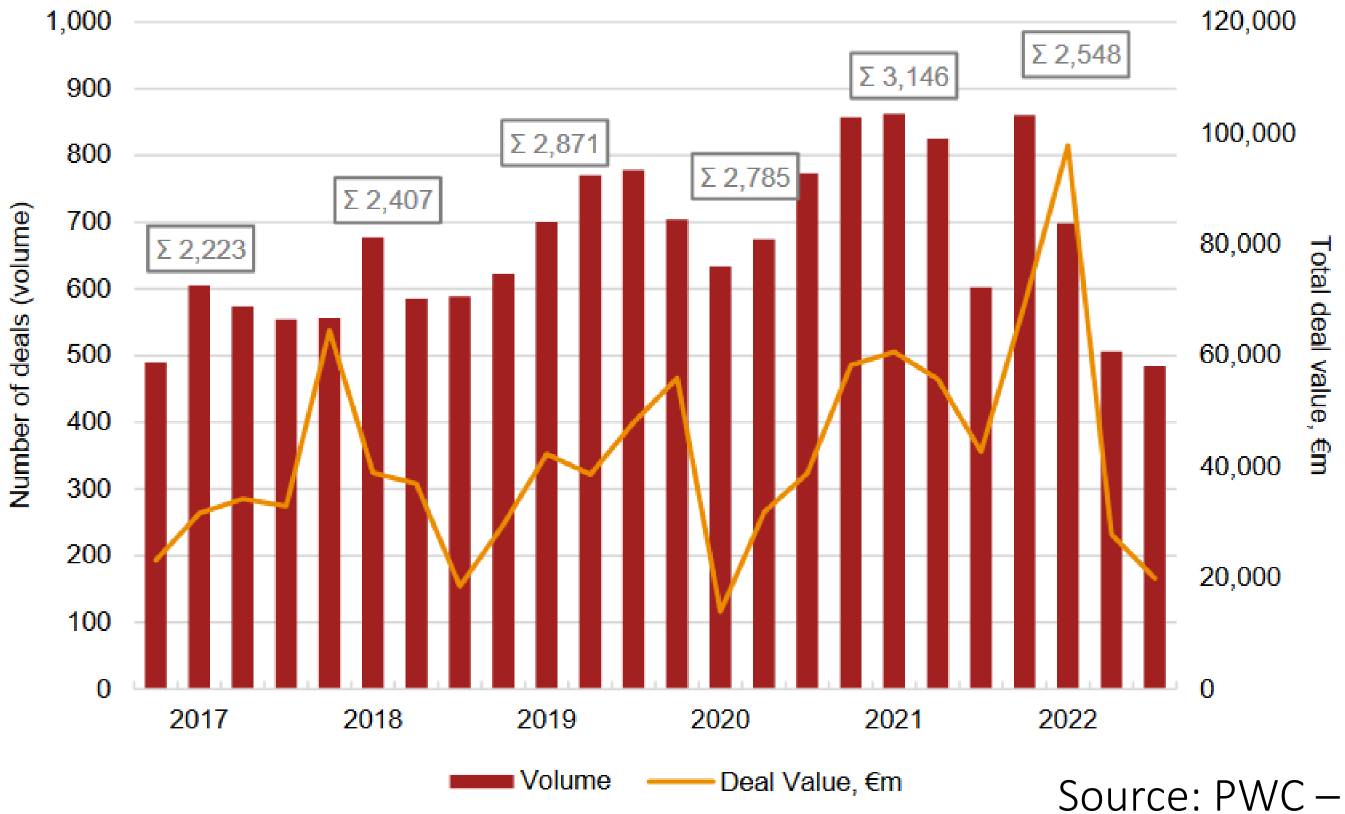
➔ **PE volume was down by 19% year-on-year (YoY) to 2,548 transactions.**

➔ **Deal value remained stable - declining slightly by 1% YoY t0 €2.14.8 bn.**

This down trend in Europe was due to the war in Ukraine, general recession fears, soaring inflation and thus a slowdown in PE markets and the fact that dealmaking roared to all-time highs in 2021 after the short pause markets took in 2020.

European Private Equity Trends

European Private Equity Trends 2017-2022



Source: PWC – Private Equity Trend Report 2023

What are the solutions that can be implemented?

National accounting rules: use average fair values instead of date values and/or take into account the intended holding period. Usage of write-ups would incentivise equity investments.

Solvency II: use the new Long term equity investment category. As for participations the capital charge is only 22%. But you have to commit yourself to hold the equities especially designed for at least 5 years.

➔**But the most efficient would be: align Solvency II-provision calculation to the new IFRS 17 VFA measurement**.

IFRS 17 VFA approach

If the technical reserves depend on the performance of the underlying assets, the discount rate can be adjusted to the characteristics of these assets.

This means that if stock markets go up, discount rates go down and technical reserves should be higher. Then shareholders equity is lower and there would be less incentive to increase the portfolio of equity investments.

If the stock markets go down, it would be the opposite. The incentive to invest into equities would be higher. This would bring a stabilising instrument to the financial markets.

➔Today Banking prudential rules (Basel III) use IFRS provisions and classifications in order to calculate risk and equity factors. Solvency II does not.

Example 1: Situation of High Interest Rates

Example: Situation of High Interest Rates

HGB - German Accounting Standard

Guaranteed Interest Rates	4%
Market Interest Rates	6%

Assets		**Liabilities**	
		Shareholders Equity	1.5
Investment	80		
		Technical Reserves	78.5
Latent Reserves	10		

Solvency II - without transitional measures

Assets		**Liabilities**	
		Solvency capital	2.5
Investment	90	Technical Reservces	87.5

Solvency capital and Technical reserves are higher higher than under HGB

Source: Own Representation

Example 2: Low interest rate without transitional measures

Example: Low interest rate without transitional measures

HGB - German Accounting Standard

Guaranteed Interest Rates	4%
Market Interest Rates	3%

Assets		**Liabilities**	
		Shareholders Equity	1.5
Investment	80	Technical Reserves	78.5
		ZZR	6
Latent Reserves	10	Latent reserves load shareholders equity	4.5
		Balance	5.5

Solvency II - without transitional measures

Assets		**Liabilities**	
		Solvency capital	-21.4
Investment	90	Technical Reservces	111.38

Solvency II indicates a shortfall in cover at an early stage

Source: Own Representation

IFRS in Low-Interest Rates

In the low-interest phase, IFRS serves as a warning indicator for capital investment

IFRS

Guaranteed Interest Rates	4%
Market Interest Rates	3%

Assets		**Liabilities**	
		Shareholders Equity	1.5
Investment	90	Technical Reserves	111.38
		Latent reserves load shareholders equity	21.38
		Balance	-19.88

Solvency II - without transitional measures

Assets		**Liabilities**	
		Solvency Capital	-21.4
Investment	90	Technical Reserves	111.38

Both sets of provision show a high shortfall

Source: Own Representation

IFRS – sustainable investment

IFRS enables an assessment of the sustainable capital investment

IFRS				**Solvency II - without transitional measures**			
risk-aversion investment							
Guaranteed Interest Rates	4%						
Market Interest Rates	3.50%				3%		
Assets		**Liabilities**		**Assets**		**Liabilities**	
		Shareholders Equity	1.5			Solvency capital	-21.4
Investment	90	Technical Reservces	88.5	Investment	90	Technical Reserves	111.38

Investment strategy enables overcoming solvency shortfall

Source: Own Representation

Alignment of Solvency II with Transitional Measures

Alignment of Solvecy II with transitional measures

IFRS				**Solvency II - with transitional measures**			
risk-aversion investment							
Guaranteed Interest Rates	4%						
Market Interest Rates	3.50%				3.75%		
Assets		**Liabilities**		**Assets**		**Liabilities**	
		Shareholders Equity	1.5			Solvency capital	1.5
Investment	90	Technical Reservces	88.5	Investment	90	Technical Reserves	88.5

Numbers are identical again

Source: Own Representation

Conclusion

An alignment of Solvency II to IFRS 17 could incentivise insurance companies to increase their investments into liquid equity instruments.

National booked value based accounting rules are outdated and should also be aligned to a market based economic risk management approach in order to anticipate critical situations such as inflationary impacts.

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