Investing for the future in a low-yield and high-uncertainty environment

Keynote speech by Petra Hielkema at the FAROS Frühjahrsforum, Frankfurt am Main

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Introduction

A very good morning to you all.

Thank you so much for inviting me here today. It is a real pleasure to open this event. Although I have been in Frankfurt since September last year when I took up my post as Chair of EIOPA, this is my first in-person speaking engagement in the city and I am very glad that it is here with you.

When I was first approached about the post of Chair, I had many factors to consider.

Some of the these were short-term: how would we as a family organise ourselves, but others were longer-term: what would the role bring in the future – and here I was thinking not just about my own career, but very much about strengthening insurance and pensions supervision at European, if not global, level. Creating a stronger, safer, financial system for citizens in this period of transition in many ways.

And today, this morning, when I think about joining EIOPA eight months ago it seems – on the one hand, like just yesterday, but on the other hand, it feels like another world: The COVID crisis, while not gone, has given way to the Ukraine crisis; the low interest rate environment, while also not gone, has lost top billing to inflation.

And while these things pose challenges, also for the insurance and pensions sectors and their supervision, I don’t want to lose focus of the big picture: fostering strong and resilient sectors, strengthening a common approach to supervision.

Why am I sharing this story with you?

Well, I think that there are parallels between the decisions that I had to take in becoming Chair of EIOPA and the investment decisions that you take.

In both cases, we are shaped by short-term and long-term needs, by the external environment and the overarching desire for a good return at the end of the day.

And this brings me to what I would like to talk to you about today: About the challenges and opportunities that we are facing today and the importance of thinking long-term, especially in the face of a low interest rate environment and uncertainty.

In my intervention today, I will touch upon where we are now; the opportunities for long-term investors; and what we as a supervisor are doing to adapt our regulatory frameworks to the current environment.

The big picture: Where we are now

For so many of us and in so many circumstances, we do not know what the future holds, but a good starting point is looking at where we are today.

So let me start with exactly that – the big picture.

The low yield environment has overwhelmingly shaped investment decisions over the last decade.

Moreover, it is resulting in a structural change that can be witnessed in the European insurance and pension market, where the pension sector is clearly moving from defined benefit (DB) to defined contribution (DC) and insurance products move more and more from life-insurance with a guarantee to unit-linked. Interestingly, this move is less visible in the German market, but is for sure the trend in the EU.

This move, however, provides challenges to insurers, pension funds and of course to policyholders, pension scheme members and savers. Consumers holding insurance-based investment products or participating in defined contribution pension schemes suffer from lower returns. The strain on long-term savings makes it difficult for consumers to build-up sufficient savings. Not only does this make it more difficult for people who are relying on returns from investments for a secure and solid income, but it also leads to the search for yield, which for some involves risk that they are unaware of or unprepared for.

Two years ago, COVID-19 brought a new threat to the market with the risk of volatility and disruption. That governments did not hesitate to act to protect their economies and people is a good thing, but it also meant that central bank intervention measures prolonged the effects of the 'low for long' interest rate scenario.

Yet, the insurance and pension sector itself is in relatively good shape. Overall, the financial sector and in particular insurers and pension funds entered the COVID crisis well capitalised and in robust position and this has allowed them to move relatively smoothly though the crisis.

The good position of the financial sector is in part a result of the lessons learned – and steps taken – following the last financial crisis in 2007. And here, I have to mention Solvency II and the positive effect that the framework has had on the sector in terms of governance, solvency and stability. It is also thanks to Solvency II that the sector weathered the COVID storm so well.

But we need to keep in mind that the COVID crisis is not yet over and it still has the possibility to bring further disruption and jeopardise the economic recovery. Especially, we still need to see the full impact of all measures taken during that crisis, for the success with which governments and central banks managed the crisis, might be the start of new challenges.

And indeed already at the start of 2022 we are seeing a new phenomenon with high inflation but with yields remaining at very low level.

And on top of this, we now have the war in Ukraine.

Let me say outright that EIOPA condemns the Russian invasion and stands with all European institutions in solidarity with the people of Ukraine. We support the sanctions against Russia and stress the importance for industry to implement them.

As with COVID, we are paying close attention to the impact of the crisis on the sectors we supervise.

Of course there is the human dimension to the crisis, and here we applaud the efforts made by companies to evacuate their employees, and the support offered by the Polish insurance sector and others.

When looking at impact from our analysis, we see that there is a very limited direct impact on the insurance and pension sectors. Direct exposure from both the insurance and occupational pension sectors to Russia is low – around 0.1% for insurance and 0.2% for pensions.

But that doesn't mean we can be complacent. We are also mindful of the indirect impact of the war.

The challenges I mentioned earlier are exacerbated by this crisis. Oil and gas price are rising as are the prices of other commodities and food prices – this will have a big impact on inflation. Moreover, volatility has gone up significantly.

Low yields combined with market shocks remain an overall risk for the market. We know from the stress test that we did last year that the market can cope, that the sector is resilient, but we are cautious all the same. And we will continue to monitor closely all the risks that we see.

Now before we can look forward, let me first say a few words about the make up of the asset allocations of European insurers.

Allocation have remained broadly stable on aggregate, with dominant exposures towards fixed income assets and equities.

Government and corporate bonds make up around two-thirds of the total investment portfolio whereas equities (listed – 5% and unlisted – 11%) follow in terms of materiality.

On the aggregate market level, we are seeing a slight shift from corporate bonds towards equities.

When it comes to occupational pensions, asset allocations for IORPs differ from those of insurers as – generally speaking – IORPs have lower exposures towards fixed income assets and higher exposures towards equity and property.

For IORPs, investments in bonds represent around 40% of total assets and over 20% in equities (70% listed, 30 % unlisted).

Investment decisions for insurers and IORPs are increasingly difficult amid the uncertainty in financial markets.

The low interest rate environment supports investment in other asset classes, such as mortgages and loans (for insurers below 6 %) or properties (for insurers over 2%). Yet although alternative investments are on the rise, they are still very limited compared to total assets, accounting for much less that 1% for insurers.

So that's where we are. And now the question is where do we go from here? Where do we turn if we want those good returns at the end of the day?

Opportunities from the green and digital transition

Well, the short answer is we are in transition in many ways and this transition has been accelerated by COVID-19. Our recovery from COVID is a catalyst for the transition of our economy – to speed up our journey to a green and digital future.

The need for transition is obvious.

Climate change and weather related events are in the headlines almost every day, often with too great a human – and economic – cost.

As for digitalisation – this is one of the great effects of COVID – the accelerated digitalisation of so much of our society.

So I would say that if we are looking for those good returns, we have to look at how and where we can invest in our green and digital transformation.

And, as long-term investors, it's clear that insurers and pensions funds are natural partners to support the greening of the economy.

Insurance companies and pension funds can choose to invest in new technologies, in climate change adaptation projects, or by incentivising businesses to operate more responsibly.

Recovery from the pandemic underscored the urgency to complete the Capital Markets Union, so that we can create a truly single market for capital that will facilitate long-term investment and foster a strong and resilient economy and society, with investment in digital and green projects at the core.

Adapting regulatory frameworks to the opportunities

What I want to underline is that while there is volatility and uncertainty, the challenges that we face also provide us with opportunities.

And at EIOPA, one of our roles – as a European supervisor – is to make sure that the regulatory frameworks that are in place can support these opportunities.

Here let me say a few words about run offs.

Run offs

The run-off business model can – when properly and fairly managed – bring benefits to the insurance market and to policyholders. And currently, we are seeing an increase in the interest of investment entities, such as private equity, in acquiring run-off (re)insurance undertakings or portfolios.

However we have been alerted to some issues, related to the supervision of run-off undertakings or portfolios because of their specific risk profile and because of difficulties in the process and assessment of change of ownership.

In these cases, supervisory authorities are attentive to any impact of policyholder protection.

Yet we do need to ensure there is a convergent approach to the supervision of run offs and therefore EIOPA is issuing a supervisory statement on this topic. In this statement EIOPA indicates that in our view, when a run-off portfolio is acquired or transferred, it is essential that the risk profile of the acquirer does not go beyond its risk tolerance and risk bearing capacity and that this needs to be assessed.

We also expect the acquirer to remain profitable in the near future, to ensure full compliance with Solvency II rules relating to technical provisions and capital requirements and to ensure the fair treatment of policyholders. With the supervisory statement we strive to bring more clarity on what is expected and enhance convergence.

Solvency II

Now let me move to Solvency II.

At the beginning of my speech, I said that the insurance sector entered the COVID crisis in a good position, in part thanks to the Solvency II framework.

This is true – the insurance industry now uses a risk-based approach to assess and mitigate risks. It also has better aligned capital to the risks it runs. Insurers have significantly strengthened their governance models and their risk management capacity.

But we are also aware that Solvency II was conceived in a very different time – one where low interest rates were not persistent. And this is one of the reasons why in the review of Solvency II, EIOPA reiterated its advice to change the treatment of interest rate risk to ensure that insurers hold enough capital for that risk.

In addition, EIOPA proposals included changes to interest rate curves used by insurers to value liabilities, specifically in respect of the extrapolation of those curves. The changes increase the influence of market interest rates on the extrapolation of the curves, making the liabilities more realistic and improving incentives for risk management.

At the same time we also recognize the possibility that a more favourable, yet prudent, approach can be taken in the framework to support investment in illiquid assets, concretely by providing room for easing capital requirements when it comes to investments backing illiquid liabilities.

I am happy that, broadly speaking, the European Commission has accepted the recommendations in our Opinion and incorporated them into their proposal.

In terms of specific proposals relevant for long-term investors, let me first mention improvements to the volatility adjustment.

These improvements are designed to increase the effectiveness of the VA in curbing short-term volatility and in rewarding insurers and holding illiquid liabilities.

In Solvency II as it currently stands, we have said that you can compensate 65% of the spread for all liabilities. EIOPA has proposed that you can compensate 85% of the spread if you have illiquid long-term liabilities because you will not sell the assets tomorrow.

Further, from a prudential perspective it is important whether during periods of adverse market volatility and insurer is forced to sell its equity or can hold on them. Equities that back illiquid long-term liabilities are more capable of being held on to. Therefore, a more favourable treatment is justified.

Indeed, the view is that by facilitating access to favourable treatment for long-term equity investments, the review of the eligibility criteria for the long-term equity asset class would support insurers ramp up their contribution to the economic recovery and the long-term financing of European businesses, in a prudent manner.

Nonetheless, our overall intention should be prudent and we see that there is room to be more favourable yet still prudent and this will remain a point of principle for us as we enter this last stage before the revised framework enters into force.

Let me also say something about the proposed amendments to Solvency II that related specifically to sustainability.

We welcome the Commission’s proposal to give us two additional mandates in sustainability risks – one relating to the regular reassessment of natural catastrophe underwriting risk capital charges; and the other to the analysis of the prudential treatment under Solvency II of assets and activities associated with environmental and social objectives.

In both cases, EIOPA believes that these proposals will contribute positively to the transition to a more sustainable economy and that insurers, in their role as investors and risk managers, can facilitate this.

However, when we adapt our frameworks, we cannot compromise risk management or – at the end of the day – policyholder protection. This means that we will only introduce changes to our regulatory frameworks if these can be supported by evidence.

We have to balance higher return with appropriate risk management. And on this point, at EIOPA, we are unwavering on this.

SFDR

Given the enormous interest in sustainability and sustainable finance, it is clear that investments in green products and projects will be seen as the good choice: good for the environment, good for business and good for PR.

So we have to be mindful of greenwashing. We have to make sure that green investments are labelled correctly, that labelling is clear and universally understood, and that there is little scope for surprises later on.

The EU Taxonomy and Sustainable Finance Disclosure Regulation will prove invaluable here.

The Taxonomy will ensure that we are speaking the same language when we talk about sustainable investments.

The SFDR sets out the environmental, societal and governance disclosures that must be provided by all financial market participants, including asset managers.

The aim is to increase the transparency and comparability of sustainability-related disclosures.

The SFDR applies to all financial market participants with over 500 employees. This means that it applies to insurers and pension funds alike, if the have over 500 employees.

However, we know that most occupational funds in the EU are not required to report on principal adverse impact because they are below the SFDR threshold of 500 employees.

Nonetheless, I do believe that we should encourage pension funds to make an effort to disclose on the principal adverse impacts under the SFDR regime as this will help to enhance the accountability of pension funds.

Disclosures will help pension fund providers to show to the public how they engage with investee companies and whether the adverse impact of their investments reduces over time.

Digitalisation, including crypto and DORA

Before I conclude, I would also like to say something about digitalisation.

We are well on our journey to a digital Europe and the pace is increasing everyday.

For investors, FinTech and InsurTech offer innovations that are ripe for investment. As a supervisor, our role is to ensure that we foster innovation while maintaining consumer protection.

And so as part of our work to support the development of a digital internal market, we will assess what needs to change in our regulatory frameworks, including IORP II, from a digital perspective and how we can address ‘same activity, same risk, same rules’ issues, while remaining technology neutral.

We are also keeping a close eye on particularly high-risk digital activity, such as crypto assets.

Indeed, last week together with the European Banking Authority and the European Securities and Markets Authority, we issued a warning to consumers on these. We want consumers to be aware that despite the aggressive promotion of these products, they are not suitable for most retail consumers, either as an investment or as a means of payment.

We must also be aware of the associated risks of digitalisation – and here I am referring to cyber attacks.

Here again, we will assess the legal frameworks that we need to protect the industry from cyber threats and attacks.

We have long highlighted cyber security and ICT resilience as critical factors and will focus our immediate work on the implementation of our recently adopted cloud computing and ICT guidelines, as well as the implementation of the Digital Operational Resilience Act, or DORA.

With the right frameworks in place, including the right security measures against threats, we can create an environment that better suits long-term investors as well as long-term investment in Europe's economy.

Conclusion

Let me conclude where I started.

Our investment decisions are guided by many factors.

Without doubt, these days those factors include the many uncertainties we are facing: Ukraine, COVID, inflation.

We must manage these challenges, but in doing so we mustn't lose sight of our long-term goals.

And in the search for yield, I want to underline that we have opportunities too. Especially for those who are ready for long-term investments, for sustainable investments and for investors in digital innovation.

The opportunities are certainly there – but we must approach them without compromising risk management.

And as a supervisor, just as we consistently monitor the market for the shocks to the system, we are also review and adapt our regulatory frameworks and supervisory practices to create conditions to foster long-term investment.

Because, in the face of uncertainty, we know that long-term investments are what is needed to support a sustainable society and stronger economy.

Thank you very much and I look forward to answering some questions.

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