Position Paper

Insurance Europe's comments on the ELTIF Proposal

Our reference:	ECO-INV-13-208	Date:	25 November 2013
Referring to:	European long-term investment funds (ELTIF) proposal		
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Pages:	3	Transparency Register ID no.:	33213703459-54

General comments

With €8.4trn of assets under management at the end of 2012, **insurers are the largest institutional investors** in Europe. The primary role of the insurance industry is to provide protection, risk transfer and to manage savings for retirement.

Insurers play an **important role in supplying the funding needs of governments, businesses and households** via significant investments that they hold in government, corporate and covered bonds (which represent 60% of the €8.4trn of assets under management), as well as in other assets such as public equity (15% of total assets), securitisations, infrastructure, venture capital, direct loans, etc. While insurers can help support economic growth in Europe through these investments, policymakers should be aware that insurers' investment in long-term assets is a natural consequence of their liabilities, ie **investing in assets is not an aim *per se*, but a consequence of insurers' primary role** of providing protection and managing policyholders' savings.

Three main factors drive insurers' investment decisions: the profile of their liabilities (in terms of liquidity and duration), the risk-return profile of available assets and the framework conditions, such as prudential, accounting or taxation requirements. Alongside the risk/return profile of assets, prudential rules for investing have the potential to affect insurers' investment decisions; for example, capital requirements encourage insurers to invest in assets that remain attractive when prudential capital requirements are taken into account.

The availability of assets is crucial to the significant investment role that insurers play in the economy. Insurers need access to a wide range of assets that enable them to match their liability needs and that allow for portfolio diversification. In particular, the industry would welcome an increased supply of and easier access to long-term assets with attractive risk/return profiles with which to back long-term liabilities. Given their illiquid and long-term liabilities, insurers are some of the few investors who can invest in illiquid assets.

While ELTIF appear to have significant potential to respond to insurers' liability-generated portfolio needs, **the prudential treatment of these assets under Solvency II plays an important role in defining their attractiveness for insurance companies.** The ELTIF proposal, as currently envisaged, **has the potential to create capital disincentives from two perspectives:**

- With respect to **available capital**, the price volatility generated by the secondary market trading would generate **volatility** in insurers' own funds and solvency positions, despite the fact that insurers would use these assets to match long-term and illiquid liabilities.

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- With respect to **required capital,** reflected in the solvency capital requirement (SCR) for ELTIF, the currently envisaged capital charge for ELTIF would be at 49%, similar to that applied to the most risky equities. We consider that such a charge is not reflective of the long-term risks actually faced by an insurance company investing in ELTIF. We would therefore advocate that **the capital treatment of ELTIF should reflect the real risks embedded in the funds' long-term and illiquid underlying assets.**

Unless these capital/volatility issues are addressed, interest in ELTIF from insurance companies will be very limited. This would be a shame, since holders of long-term illiquid liabilities such as insurance companies are in our view the main and potentially the only investors who would be interested in them. Insurance Europe would be happy to **engage in discussions on how Solvency II Delegated Acts can be adapted in order to reflect an appropriate treatment of ELTIF** and thus help make them a viable investment for insurance companies and support their success.

We present below more detailed comments regarding the proposal:

- The ELTIF framework is dedicated to both institutional and retail investors

Institutional and retail investors exhibit different investment behaviours. While long-term institutional investors, such as insurers, have the expertise, the willingness and the ability to invest in assets with a long-term perspective, this is often not the case for retail investors. Due to a range of reasons, such as a lack of investment expertise or the need for liquidity, retail investors are often tempted to trade more and to exit investments before their pre-defined maturities.

Given the existence of a secondary market for trading ELTIF, the investment behaviour of retail investors has the potential to generate volatility in the market value of the funds, which would ultimately translate into volatility in insurers' balance sheets.

We therefore believe that a two-tier system — one dedicated to institutional investors and one to retail investors — would be more appropriate for fulfilling the ELTIF objectives.

- Investment restrictions on derivatives and borrowing of cash (Articles 8 & 14) have the potential to prevent optimal capital management

In order for ELTIF to represent a realistic option for long-term investments, it is important to strike the right balance between the illiquid nature of the underlying assets and the possibility to manage the funds in an efficient way. The latter concerns in particular the proposed rules on access to liquidity, where overly restrictive provisions could undermine the functioning of the ELTIF. Insurance Europe fears that the proposal underestimates the multi-dimensional value of liquidity for the management of illiquid assets, which could unintentionally preserve current barriers to investment in illiquid assets.

While we agree that derivatives should be used for hedging purposes only, restricting the scope of risks eligible for hedging to interest-rate and foreign-exchange risks is inappropriate, especially given the profile and characteristics of eligible investment assets. For example, it is often the case that derivatives on commodities are needed to hedge construction and development risks of large infrastructure investments. We therefore believe that no restrictions should be placed on the type of risks to be hedged.

In addition, according to the proposal, ELTIF cannot engage in securities lending and repo transactions. This could seriously affect effective capital management (not least in relation to collateral requirements in EMIR), especially given the restrictions on borrowing in article 14. We believe that securities lending and repos should be allowed for efficient portfolio management (including for cash-gathering for EMIR collateral requirements).

It is also unclear how an ELTIF will be able to post collateral for loans, since the provision in article 14 (e) states that borrowing must not encumber the assets held in the portfolio of the ELTIF. This could potentially imply that a form of external guarantee/guarantor would always be needed, which is both not desirable and little feasible in practice.

- Rigid diversification limits (Article 12)

The ELTIF proposal defines very rigid diversification limits. Given the illiquid nature of underlying assets, portfolio rebalancing in the case where a limit is surpassed (due to valuation changes) is not as straightforward as for liquid securities. We believe that diversification limits should also be able to reflect the illiquid nature of underlying investments and to provide more flexibility in order to minimise the costs potentially caused by forced sales of illiquid assets.

- Regulatory and prudential treatment of ELTIF under current local regimes

A range of national regulations (via Solvency I) impose restrictions regarding investments in funds other than UCITS. Such restrictions should be eliminated to allow investments from insurers. In addition, Solvency I rules in a range of jurisdictions are currently designed to prevent insurers from investing in non-redeemable structures. Only the elimination of such limitations would allow insurers to invest in non-redeemable ELTIF structures prior to Solvency II coming into effect.

- Eligible investment assets (Article 9)

Investments in assets such as infrastructure projects often require intermediate holding entities able to, for example, facilitate co-investment in a very large project. The current proposal does not fully allow for this requirement. According to the proposal, ELTIF cannot invest, for example, in a qualifying portfolio undertaking through a private equity fund. The reason for this restriction is unclear. We advocate the extension of the scope of eligible assets, in order to allow for both direct and indirect exposures in illiquid assets. Such an extension of the scope should not endanger the transparency in the fund, so transparency regarding underlying assets and exposures has to be appropriately addressed and ensured by the fund manager(s).

- Other concerns

We believe that the distribution of cash flows is a crucial point in the design of the framework, as cash flows could potentially serve asset-liability management purposes. As this is of the utmost importance in making the ELTIF proposal attractive to insurers, we would advocate that more clarity is given on how regularly cash flows would be distributed (Article 20).

In addition, question marks remain over the liquidation of the fund in the case of failure. Given investors' commitment to be invested for a pre-specified period, it is not clear how much and when the funds would be repaid if the fund has to be liquidated.