Position Paper

Response to consultation on removal of mechanistic references to credit ratings in ESA guidelines and recommendations

Our reference:	ECO-INV-13-216	Date:	5 December 2013
Referring to:	ESA's public consultation on the removal of mechanistic references to credit ratings		
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Pages:	3	Transparency Register ID no.:	33213703459-54

European insurance companies have a keen interest in the policy debate on credit rating agencies (CRAs), notably because of the impact such a debate can have on the ability of insurers to play their role in the financial markets as the largest institutional investors. Insurance Europe has engaged in such discussions also within the context of the Solvency II and Omnibus II Directives.

(i) Proposed definition for mechanistic reliance

Insurance Europe supports the definition put forward by the ESAs, which states that: "…there is *sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule solely based on credit ratings (or credit rating outlooks) without any additional discretion."*

Insurance Europe considers that this definition appropriately reflects the fact that whenever investors — as users of credit ratings — have discretion over their investment/disinvestment actions and whenever such actions are determined by a range of parameters and not solely by credit ratings-based rules, such use of external credit ratings cannot be considered as "mechanistic".

However, some complementary elements of this definition would be welcome: for instance, it might be appropriate to more clearly identify the distinction between ratings and outlooks, which is of high relevance. Similarly, the terms "solely" and "additional discretion" are broad and would deserve more detailed explanations/definitions, particularly in the context of insurance prudential rules.

(ii) References to credit ratings in the Solvency II/Omnibus II Directives

The Solvency II Directive introduces a well-harmonised, EU-wide prudential regulatory framework. It introduces an appropriate risk-based approach to capital adequacy instead of the existing national frameworks, which are very often highly prescriptive about insurers' asset allocations. Solvency II eliminates asset allocation restrictions, while ensuring that insurers have sufficient capital and appropriate risk management to protect themselves from the risks to which they are exposed.

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Insurance Europe supports, in principle, the need to reduce the over-reliance of financial markets on CRA ratings. It should, however, be recognised that in practice it would neither be feasible nor desirable to refrain from any reference to external ratings. Legislation in this area should take into account the nature, scale and complexity of insurers' business and investments. In our view, this is achieved by the Solvency II framework, as explained in more detail below.

Insurance companies' primary role is to provide protection from risks and offer long-term pension products to policyholders. As a consequence of this role, insurers invest in assets until claims or benefits become due. Insurers' investment decisions are therefore primarily driven by the profile of their liabilities (in terms of duration and liquidity). The risk-return profile of assets is another important factor insurers take into account when they invest.

Insurers will either perform their investments internally, within the investment department/function of a company, or externally, via a mandate that is given to an external asset manager. Irrespective of the approach taken, the investment decisions require a complex set of factors to be taken into account and are not solely (and often not at all) based on the credit rating of a given investment product. The role of internal credit risk assessment in this process is limited to specific cases where scrutiny of the external rating is appropriate.

Not only do insurance companies have limited interest and ability in developing exhaustive credit risk assessment models, but they also do not have the special expertise, access to a wealth of internal information and ability to make use of economies of scale and scope that CRAs have, and which make it possible for them to issue credit ratings. It is very difficult to imagine how such a complex business model could be replicated within an insurance company.

We therefore believe that the current provisions of the Solvency II Directive are appropriate and that any obligation to carry out own credit risk assessments for every entity or financial instrument would not be a helpful proposal and could contradict the principle of proportionality.

The recent Omnibus II trialogue agreement gives due consideration to the difficulties that insurers might face in developing their own risk assessment models:

"In order to avoid overreliance on external credit assessment institutions when they use external credit rating assessment in the calculation of technical provisions and the Solvency Capital Requirement, insurance and reinsurance undertakings shall assess the appropriateness of these external credit assessments as part of their risk management by using <u>additional assessments wherever practically possible</u> in order to avoid any automatic dependence on external assessments."

(iii) How certain asset restrictions can create risks of cliff-edge effects

One of the features of Solvency II is to remove the distortionary effects of overly prescriptive regulation. In principle, any proposal that requires insurers to hold only bonds that are above a certain credit rating can distort their market price. It would artificially depress investment in bonds with ratings below the threshold, while at the same time artificially increasing investment in those with ratings above it. Such restrictions, when they lead to immediate and significant capital penalties for the insurance company as soon as a threshold is reached, create pro-cyclical, "cliff-edge" effects. Thresholds that can create these cliff-edge effects and other unintended consequences should therefore be avoided. Instead, capital requirements should be set in line with the Solvency II Directive, ie, the higher the risk, the higher the capital required.

The insurance industry agrees with the elimination of such provisions in the recent Omnibus II discussions regarding the matching adjustment and namely the Council text highlighting that "*the credit quality limits for matching adjustment assets have been removed to enable undertakings to avoid the risk of cliff-edge effects in case a matching portfolio unexpectedly became ineligible, e.g. because of downgrading of the bonds, and the potential for assets fire sales."*

Looking ahead, Insurance Europe believes that the Solvency II delegated acts should be designed to appropriately reflect insurers' limited capacity to develop their own credit risk assessment models and therefore avoid forcing the insurance industry to develop complex expertise that is irrelevant and is a very limited addition to the insurance value proposition.