SOLVENCY 2 IMPACT ON EUROPEAN BOND MARKETS

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redefining / standards

Solvency 2 impacts on bond markets: *main take-away*

- ECB & Basel III have been and are heavily impacting the European bond market, and as such are dwarfing Solvency 2 potential impact

- Solvency 2 and low yield environment are key drivers for insurance's investment decisions

- … as well as does accelerate European insurers search for :
  - → **credit diversification into less liquid strategies: private corporate debt, social housing, Commercial Real Estate loans …**
  - → **alternative long duration assets: infrastructure, residential mortgages, Export Credit Agencies, supranational/multilaterals**

- And Solvency 2 fosters new behaviors:
  - → **more barbells**
  - → **regulatory capital efficient risk premia strategies**
  - → **hedges: options and CDS index/basket tranches**

Solvency 2 impacts on bond markets: *smooth but structural transition…*

- Large insurance companies prepared in advance to the new regulation:
  - → **having started to adapt their asset allocation into Solvency 2 for years**
  - → **being ready to have investment teams and business set-ups in place for new initiatives in private debt opportunities**

- Leading to a smooth transitory bond portfolio allocation process from Solvency 1 to Solvency 2 with no dramatic impacts on the European bond markets at first sight:
  - → **not easy to observe and qualify given other massive game changing/distorting forces: Basel 3 regulation and ECB Purchase Programs**
  - → **other market participants' investment decision or anticipation**

- But reinforcing insurers behaviors, fostering new ones over the long term:
  - → **more sensitive to rating stability than ever: no credit for duration**
  - → **deploying into new asset classes like infrastructure and mortgage loans, commercial real estate loans and corporate loans: number of new platforms and players in Europe**
  - → **pushing some barbells in portfolios with some allocation into higher return / risk / capital to drive upwards average investment yields: not yet signs of excessive compression, but some players expecting it to happen**
  - → **favoring Fixed Income instruments at the expense of equity markets**

Solvency 2 impacts on bond markets: *driven by both duration and yield needs*

- Driven by duration needs:
  - → **insurers' trades on swap market and option market to manage duration but constrained by other regulation like EMIR**
  - → **Hence still present the search for long dated well rated bonds, historically euro-zone government bonds, now hurt by low yield level and scarcity of the available pool:**
    - *Last 9 months of 2015, insurance companies the only residual net buyers of euro-zone government bonds with ECB: Core countries' government curve currently quite flat*
    - *Periphery government curve steeper though*
    - *Other considerations in force like ECB intervention and market participants' inflation expectations*
  - → **crowding out effects into other alternatives: sub-sovereign and agencies and outside euro-zone issuers and infrastructure private placements**

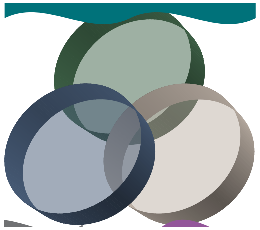
- Driven by stable investment yield needs:
  - → **preservation of average rating of portfolio driving some potential unintended pro-cyclical investment decisions during period of rating pressure**
  - → **search of yielding fixed income instruments driving moves into loan format type of investments, illiquid and private debt investments initiatives, and outside euro-zone located issuers**

Solvency 2 impacts on bond markets: *leading to unbalanced behavior?*

- European insurers bond portfolio standardization:
  - → **volatility adjuster ("VA") pushing towards standardization of the European insurers bonds portfolio allocation:**
    - *the capital charge on spread risk is directly linked to the difference between the actual bond portfolio and the notional bond portfolio on which VA is calibrated ; capital charge minimal when both portfolios identical*
    - *hence , some incentives for all insurers to try to replicate nominal portfolio into actual portfolio*
    - *no more distinction of the liquidity component at sub-asset class level*

- Worsening of the credit investment conditions – fundamentals and valuation - with the acceleration of :
  - → **the mispricing of credit risk premium across the European credit asset classes**
  - → **the deterioration of the credit fundamentals due to heavy demand: corporate leverage, credit documentation weakening…**
  - → **the squeeze of some asset classes: securitized products on top of ABSPP**
  - → **the increase of "opportunistic" leverage due to a growing supply & demand imbalance: the quest for higher yielding debt investment**
  - → **the increase of volatility due to Solvency 2 driven tail credit risk hedging behaviors using standardized CDS indices/senior tranches, while at same time Basel 3 retrenching for derivatives' market**

Solvency 2 impacts on managing bonds portfolio for insurers



Solely accounting driven:

- Long term management
- Mixing duration & credit <u>focussing on local govies and High Grade credit bonds</u>
- Low turn over, focussing on fundamentals with limited credit risk downside potential
- No direct link with Cost of capital as Solvency I is not risk based

Before 2007

Mixing economic and accounting considerations

- Long term management
- Mixing duration & credit
- Low turn over, focussing on fundamentals with limited credit risk downside potential
- No direct link with Cost of capital as Solvency I is not risk based

2008 - 2015

Monitoring accounting, ratings & mark to market valuations

- ❑Long term management
- ❑Split duration & credit risk: long term duration hedging
- ❑Low turn over, focussing on fundamentals with limited credit risk downside potential
- ❑Take on board cost of capital under Solvency II (standard or internal models)

FROM JANUARY 2016

Solvency 2 impact on bond markets: *issues for discussion*

1. Solvency 2 is a value at risk model based on current capital market valuations (which are volatile). Insurance liabilities are very long term. Does this make sense?
2. Solvency 2 investment volatilities are based on a one year horizon. Is this too short?
3. Solvency 2 models and risk drivers are very complex. Are shareholders able to understand risk positions?
4. Solvency 2 – as every risk measure – implies cyclical measures on risk reduction or risk increase. Does this serve shareholders and policyholders adequately as the insurance business is very long term?
5. Is there a standardization of credit portfolios with barbellization given volatility adjuster impact ?
6. Who can buy long dated credit assets and junior bank credit given the capital charge?
7. Where do insurers find duration in the current context in order to manage interest rate risk and associated capital charge?
8. Is the usage of derivatives to manage the tail risks and lower the capital charge compatible with the rules impacting the banks?