Solvency II and Asset Managers

What is Solvency II?

The UK regulator the Financial Services Authority provided this clear summary:

"Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current Solvency requirements."

Solvency II is an EU Directive intended to ensure that insurers have appropriate processes to understand their solvency position and sufficient capital to maintain their business. It builds on the existing Solvency I regime. EIOPA (European Insurance and Occupation Pension Authority) has been very clear that this is a principles based initiative with the intention that the solvency assessment be an integral part of the business management rather than a regulatory reporting obligation.

Generally the intention, and with three pillars structure, the format, is similar to BASEL, but is applied to insurance entities only and only within the EU. Solvency 2 is applied to all Insurance and reinsurance entities with premium income of €5mm or technical provisions exceeding €25mm, so in effect all large medium and many smaller insurers are in scope. The provisions apply to an EU insurer, the non EU subsidiaries of an EU insurer and the EU subsidiary of a non EU insurer. The start date is now January 2014 with insurance required to gain approval of their model from their local regulator in 2013.

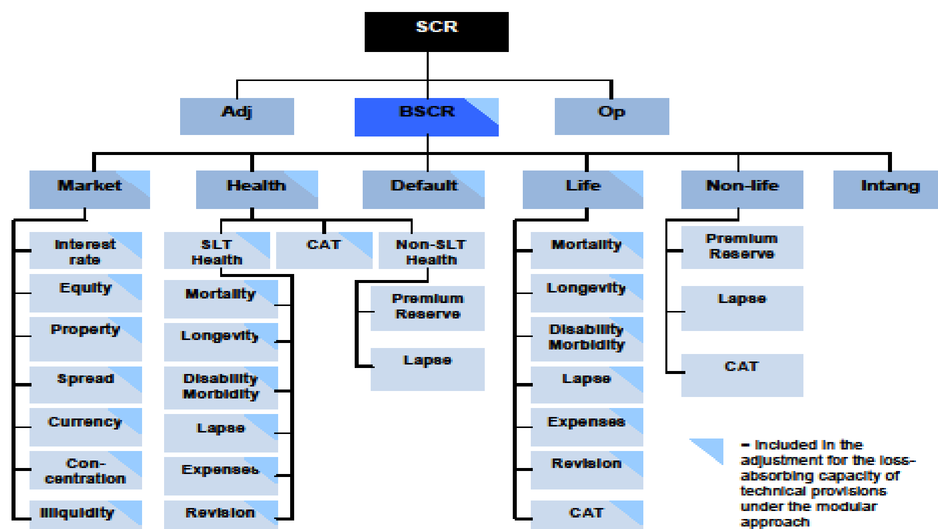
The three pillar structure broadly covers:

Pillar I – Calculation of the Solvency Position

Pillar 2 – Systems of Governance

Pillar 3 – Reporting and Disclosure

The first pillar requires the insurer to calculate their solvency position comparing their actuarial calculation of current value of liabilities to pay future claims against the value of the net assets that are held to meet these liabilities. A series of risk factors must be applied to both the projected actuarial liabilities and the net assets held to calculate the solvency position. EIOPA publish the following graphic to show the different factors to be considered in the calculation of the Solvency Capital Requirement for the insurer in their Standard model.



(Source EIOPA,)

The standard model specifies risk adjustments to be applied for each risk factor described. Not all risks will be applied for all insurers with only those appropriate to the types of business written being relevant. EIOPA has permitted Insurers to define their own internal model for assessing their solvency position using different factors and weightings should the insurer successfully demonstrate to their local regulator that such a model more accurately fits their business. An asset manager will be primarily interested in the impact of the factors covered by the Market Risk section.

The second pillar is primarily concerned with governance and control. This will impact the asset manager where the asset manager is providing data to the insurer, particularly around the validation and traceability.

The third pillar of Solvency II covers disclosure both to the regulator and for publication. EIOPA has defined Quantitative Reporting Templates (QRTs) that must be completed to satisfy this need. The templates generally cover the data required to perform the Solvency calculations under pillar 1, but there are some differences, in the data elements and level of detail required. Generally the quantitative templates allow some consolidation, but there are a small number of additional data elements required.

If Solvency II is for insurers why does it matter to asset managers?

The impact for asset managers can be viewed under the following headings:

1. Data demands
2. Look through
3. Reinsurance
4. Asset mix, changes to mandates
5. Pension funds

1. Data demands

Insurers will need data, first to generate the net asset values to take into the solvency calculation, secondly to calculate the risk factors to apply, and thirdly to look through a structure, such as a derivative or mutual fund.

When an insurer has delegated asset management they will typically be provided with periodic valuations and statements of holdings. As the insurer no longer holds all of the data they require to populate their solvency calculation they will come to their asset manager. Where the insurer has outsources administration and accounting the request may come through their service provider, but in this case could be for only those elements that are asset manager specific. Whilst much of this data will be provided for a segregated discretionary mandate, this is much less likely to be made available to an investor through a UCITS or other collective structure and certainly not on the business day 2 after the period end that has been proposed by the insurers.

There is a quarterly disclosure requirement, but many insurers have stated that they will run their solvency calculations monthly. The regulator is entitled call for a statement of solvency calculated at any time.

2. Look through

Consistent with the stated purpose of Solvency II EIOPA has been very clear, including in their response to consultation publish 10th July 2012, that an insurer must know the detail of the positions it holds including looking through structures such as UCITS and Hedge Funds to the underlying exposures. As a consequence of the timelines imposed on insurers for calculation and reporting of their solvency positions insurers are seeking to obtain the net asset data typically by day 2 or 3 of the month. For look through insurers want a statement of the value of their investment broken down to the value of the individual constituents of the fund that their holding represents. This brings two significant problems for the asset manager, how to deliver the data and whether the asset manager is prepared to make available the data whilst it remains effectively current. To address the first point a number of data providers have proposed solutions, to act as a central repository for asset managers to publish their holdings data, but there remain some key questions for an asset manager to consider:

- Do I know who my insurer investors are?
- Are there any significant insurance investments where my fund is being used in a fund of fund model?
- Do I want to publish my holdings to my insurance customer when the data remains current?
- Am I prepared to lose investment as a consequence?
- If I publish to my insurance customer will have be obliged to publish to all investors?
- Am I prepared to pay to have my data made available through a data services provider or should I agree a bi-lateral agreement with individual insurance investors?
- How much am I prepared to pay to deliver this data? – There is a cost and some insurers have described this as a cost of gaining their investment.

3. Reinsurance

In certain circumstances related to domicile and credit rating of the reinsurer Solvency II offers favourable treatment to liabilities that are passed to a reinsurer. This is in effect a risk to the asset managers business as this will reduce the assets managed, although clearly it is an opportunity to asset managers providing services to reinsurance entities.

4. Asset mix, changes to mandate

Solvency II requires the insurer to assess market risk of the assets they hold under each of the seven categories defined by EIOPA. Different asset classes are subject to different risk factors with debt issued by an EEA government given a zero risk factor under the spread risk category, and equity carrying a factor of up to 40% in the solvency calculation. It is anticipated that there will be a further move from equity to high rated debt with consequence impact for equity asset managers.

Different risk weightings are applied to different durations of debt. This could lead to a change in the asset mix held against some liabilities such as long term annuity business were traditionally long dated debt to match the duration of the liability has formed part of the portfolio held, but carries a higher weighting under Solvency II.

Where liabilities can be shown to be linked to asset values the changes in asset values resulting from applying the market risk factors can similarly be applied to the liability recognising that the market risk is being, largely, carried by the insured rather than by the insurer. As a consequence one possible result for life and pensions insurers could be a move away from traditional insurance business to unit linked policies. This could make the targeted higher returns from the higher risk equity class of investment more attractive than it would otherwise be under Solvency II.

Insurers are able to disregard higher risk assets where they are able to demonstrate that the position is hedged and it is possible that this could lead to increased use of derivatives such as to offset a currency risk with an overlay or simple share class hedging strategies.

Because of the need to match liabilities to the assets held to match the liability mandates could change to target a liability profile rather than simple returns. This could have impacts on how a fund's performance is measured an assessed.

5. Pension funds

In some EU countries the pension retirement savings industry is conducted largely through insurance companies so is subject to the requirements of Solvency II. For these countries the pension industries have additional governance and reporting obligations over and above foreign competitors. This together with a desire extend the protection that Solvency II brings to insurance consumers means that it is anticipated that EIOPA will extend Solvency II or implement a similar regime for pension schemes. Given the even greater significance of pension investments to the asset management industry a prudent asset manager should be considering a Solvency II strategy, including the context of future application to pension investment.

Opportunities Too

An asset manager who can demonstrate a "Solvency II friendly" product has an opportunity to pick up insurer investment formerly with asset managers who are unwilling to invest in such a product. Features would include:

- Delivery of complete look through data in a timely manner
- Delivery of valuation data by the appropriate categories for Solvency II
- Management against a clearly stated liability mandate
- Multi-currency hedged share classes to match different liability currencies
- Active management of hedging strategies to better match actuarial liabilities

Feedback from insurers is that many asset managers are unaware of, or unprepared for the impact and demands on them from Solvency II. Being able to articulate a clear strategy that supports the insurer compliance with Solvency II could be a competitive advantage when other asset managers are not doing so.

What Should an Asset Manager be Doing Now?

- The asset manager should want to understand the extent to which the money they manage is insurance investment. For direct mandates this is clear, but where the investment is through a UCITS or other collective structure the transfer agent is a starting source of data
- It would also be prudent to understand the extent of pension fund investment when formulating the Solvency II strategy
- Active engagement with insurance clients to capture their needs and objectives
- Developing a strategy for data disclosure – particularly look through
- Review the requirements for Market Risk – readily available from EIOPA's website (https://eiopa.europa.eu/home/index.html)
- Global Custodian and Fund Accounting service providers such as Citi Transaction Services have Solvency II programmes and can act as a useful source of information, knowledge, and practical solutions where outsourcing of these activities is considered
- Design a strategy that matches key insurance customer or potential customers, liability driven investment objectives
- Ensure that customers and potential customers are aware of the Solvency II friendly capability covering both investment objectives of the fund and the availability of disclosure data in a Solvency II