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Collective investment schemes
The impact of Solvency II

Leading business advisers

Solvency II is a new solvency regime for all EU insurers due to be implemented on 1 January 2014. The new regulations set out the capital requirements for insurance companies on a risk basis. The three pillar structure covers quantitative capital requirements, governance requirements and market disclosure.

The investment strategy of insurers and the interaction with their investment managers and other service providers are of critical importance in implementing the new requirements.

Insurance companies represent the largest single investor group in collective investment schemes. Investment managers owned by large insurance companies are already engaged in Solvency II implementation projects and are identifying the key impacts on their investment management operations. However, many investment managers and service providers have yet to fully assess the potential impact on their business. As such, this presents an opportunity for investment managers and service providers to be proactive and ensure they are on the front foot with their insurance clients and targets.

Solvency II presents investment managers with the opportunity to reassess their strategy with respect to the insurance market. Certain managers will see this as an opportunity to provide their clients with bespoke Solvency II solutions, whereas others will determine that the costs of compliance will mean they focus their products at other investors. For service providers, the ability to provide system solutions to meet information needs and to work with investment managers in providing transparency on governance requirements will set them apart from their competitors.

Pillar I: quantitative capital requirements

Pillar I sets out the minimum capital requirements and allows insurance companies to use a standard formula where capital charges are standardised by asset class, or an internal model whereby insurers calculate their capital requirements using a bespoke model.

Currently, the largest money managers are offering auxiliary services, such as advising the insurer's in-house portfolio managers and providing custom benchmarks to managing insurance company investments. These managers are currently attracting more insurance clients because their expertise offers risk mitigation whilst achieving a desired return on investments. It is likely that as Solvency II unfolds this trend is likely to continue.

The new capital requirements may change an insurer's asset allocation and investment managers should be discussing the potential opportunity to develop new products that more closely match the underlying cash flows associated with an insurer's cash flow obligations.

An additional challenge for hedge fund managers is the capital charges that are required by insurers who invest into hedge funds and use the standard formula. Investment managers with these clients will need to consider whether offering managed accounts is a better solution to offering pooled vehicles once the final rules on 'look through' have been settled. Hedge fund managers will need to provide their large insurance clients who are using insurers and use the internal model under Solvency II with adequate information to calculate an appropriate capital charge. This is likely to include historical and current risk data.

Pillar II: supervisory review

Pillar II sets out the qualitative requirements for insurance companies and defines both the principles of risk management and governance, in addition to the supervisory review.

As part of their ongoing risk assessment and monitoring, insurance companies are expecting significantly more interaction between themselves and investment managers and an increased amount of oversight by the insurer. Therefore, insurers and investment managers will need to review and potentially update the terms of their SLA to ensure that the services provided are Solvency II compliant. It is likely that these discussions will take time to complete and their SLAs will need to be amended to reflect the latest guidance.

Insurers will need to be able to conclude that the controls operating at the investment manager level are operating effectively through ongoing monitoring. Further guidance regarding the required oversight by insurers on service providers is expected as part of the Pillar II measures, but a transparent approach to insurance clients is likely to be required.

Pillar III: market disclosure

Pillar III sets out the market facing elements of Solvency II including transparency requirements, disclosure requirements and competition related elements.

There are significant additional disclosure requirements for insurers arising from Solvency II. Concerns have been raised by the insurance industry around the scope and the timetable of the reporting requirements. Under the current draft, quarterly reporting will be required by insurers within eight weeks of the quarter end from 2014, reducing to five weeks from 2017 onwards. This will require significant information to be provided by investment managers on a security basis.

Insurance companies are continuing to lobby against the proposed timeframes and the volume of information to be provided. Among the key considerations is what defines a 'hard close' and the accuracy of data that needs to be provided for quarterly reporting. For certain classes of asset, information may only currently be provided on a six monthly basis and it remains to be determined what will be required.

Given current deadlines, many insurers would need the data from their investment managers within a much reduced timeframe. This is likely to be a challenge for any asset manager, but is an even greater challenge for managers that outsource their back office function. This is likely to require a new SLA with the back office provider that will most likely come at additional cost.

Consideration will need to be given to roll forward techniques or potentially technology solutions to automate data provision.

Additionally, the specific types of data supplied by the investment manager will need to be reviewed both because of the need for detailed data to calculate the capital charge described under Pillar I, but also because Solvency II will require the insurer to disclosure far more detail about their investments. Frankly, the name of the investment, the amount owned and the current price is not likely to be sufficient under the new regime.

Next steps

The specific requirements for Solvency II are still evolving, but investment managers and service providers must consider whether their current operations can meet the future demands of insurance clients and if there is a cost benefit of changing their operating model to meet these demands. Given the implementation timeframe, those firms that start earliest are likely to implement the most effective and cost efficient processes and will be the ultimate winners.

How Deloitte can help?

Deloitte is one of the leading advisors to insurers implementing Solvency II and is at the forefront of developments and assessing their impact on insurers. We can help investment managers and other service providers identify where they stand against the current Solvency II requirements and identify solutions to any gaps.

Contacts

For more details please contact:

Deirdre Power
Partner, Head of Investment Management Advisory
T: +353 1 417 2448
E: depower@deloitte.ie

Mike Hartwell
Partner, Head of Investment Management
T: +353 1 417 2303
E: mhartwell@deloitte.ie

Glenn Gillard
Partner
T: +353 1 417 2802
E: ggillard@deloitte.ie

Matthew Foley
Senior Manager
T: +353 1 417 3861
E: mfoley@deloitte.ie

Alan Cuddihy
Director
T: +353 21 420 7824
E: acuddihy@deloitte.ie

Dublin
Deloitte & Touche
Deloitte & Touche House
Earlsfort Terrace
Dublin 2
T: +353 1 417 2200
F: +353 1 417 2300

Cork
Deloitte & Touche
No.6 Lapp's Quay
Cork
T: +353 21 490 7000
F: +353 21 490 7001

Limerick
Deloitte & Touche
Deloitte & Touche House
Charlotte Quay
Limerick
T: +353 61 435500
F: +353 61 418310

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