Solvency II and key considerations for asset managers

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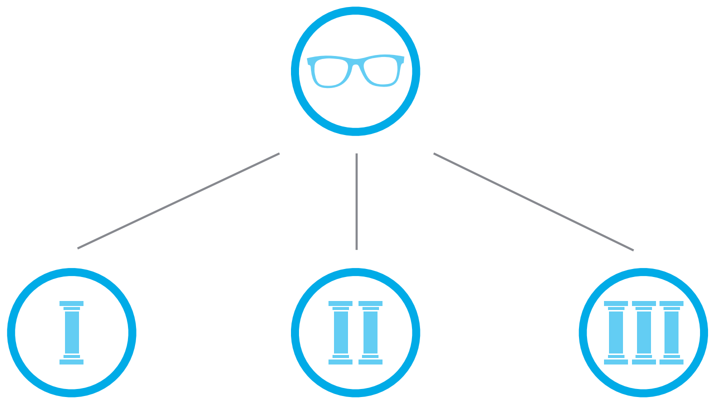
With transparency as one of the key objectives of the Solvency II Directive, look-through demands from insurance/reinsurance undertakings will increase following the implementation of Solvency II. It will also add pressure on asset managers to make further progress with regard to data quality, governance and disclosure.

Well-prepared asset managers that offer Solvency II adapted products and reporting could gain a competitive advantage.

In terms of risk factors, market risk is expected to have the largest impact, between 50 and 75 percent of the final SCR according to a recent EIOPA study

Solvency II



Pillar I
Capital requirements
- Solvency Capital Requirements
- Investment rules
- Assets & liabilities valuation
- Own funds
- Minimum capital requirement
- Technical provisions

Pillar II
Governance & suspervision
- Governance system
- Supervisory review
- Groups control

Pillar III
Disclosures
- Public information
- Supervisory reporting

■ Impact for asset managers & asset servicers
■ Impact only for Insurance undertakings

1. Solvency II – A key milestone for the insurance and reinsurance industry

The Solvency II Directive, which has come into effect on 1 January 2016, is a harmonized, risk-based supervisory framework for insurance and reinsurance undertakings in the European Union.

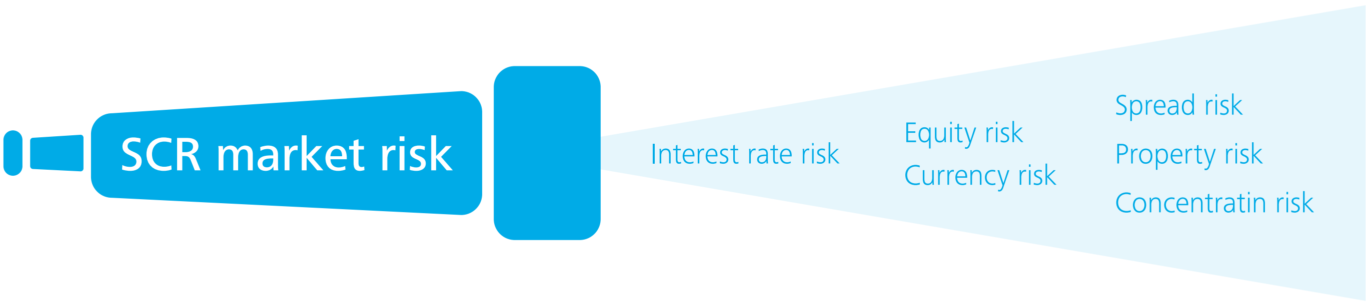
As per other financial services legislation, such as the Basel III framework for banking supervision, Solvency II has been organized in three pillars: Pillar I focuses on Solvency Capital Requirements (SCR), Pillar II centers on governance and supervision, and Pillar III addresses disclosure and supervisory reporting.

Unlike other regulatory frameworks, Solvency II stipulates that the calculation of Solvency Capital Requirements is based on a delta net asset value approach.

The insurer's assets and liabilities are subject to stress tests with pre-defined shocks set by the supervisory authority. Changes in net assets are combined with correlation matrices to derive the solvency capital requirement. Risk factors include market, health, default, life, non-life, intangible and operational risks, which makes it a complex and data-rich computational process.

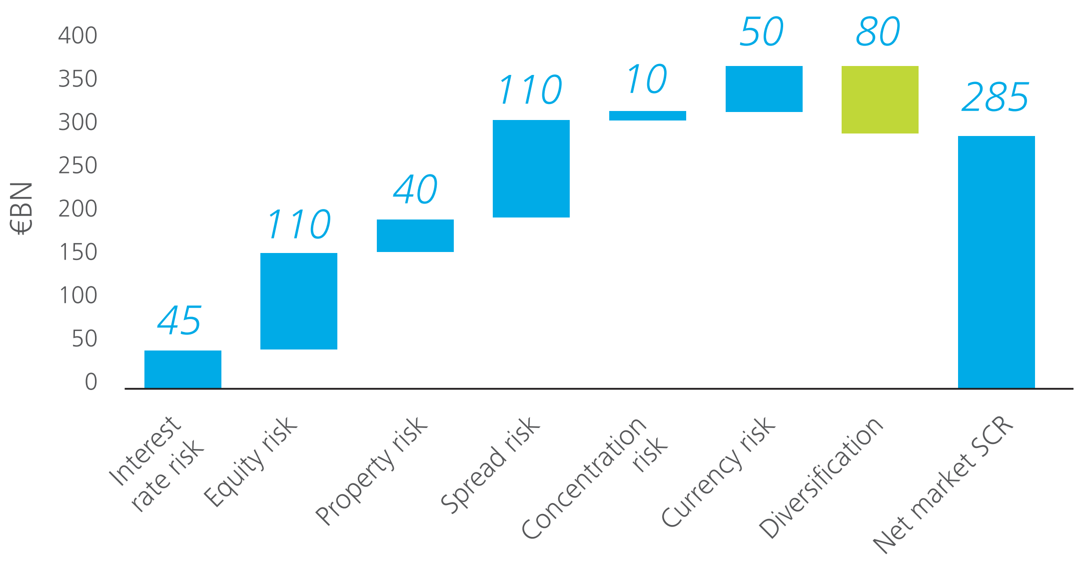
In terms of risk factors, market risk is expected to have the largest impact, between 50 and 75 percent of the final SCR according to a recent study from the European Insurance Occupational Pensions Authority (EIOPA). SCR market risk is derived from six sub-risk factors displayed below. Within market risk, equity, spread, currency and interest risks have the biggest impacts on the SCR.

Overview of SCR market risk



Market risk SCR decomposed

Core sample

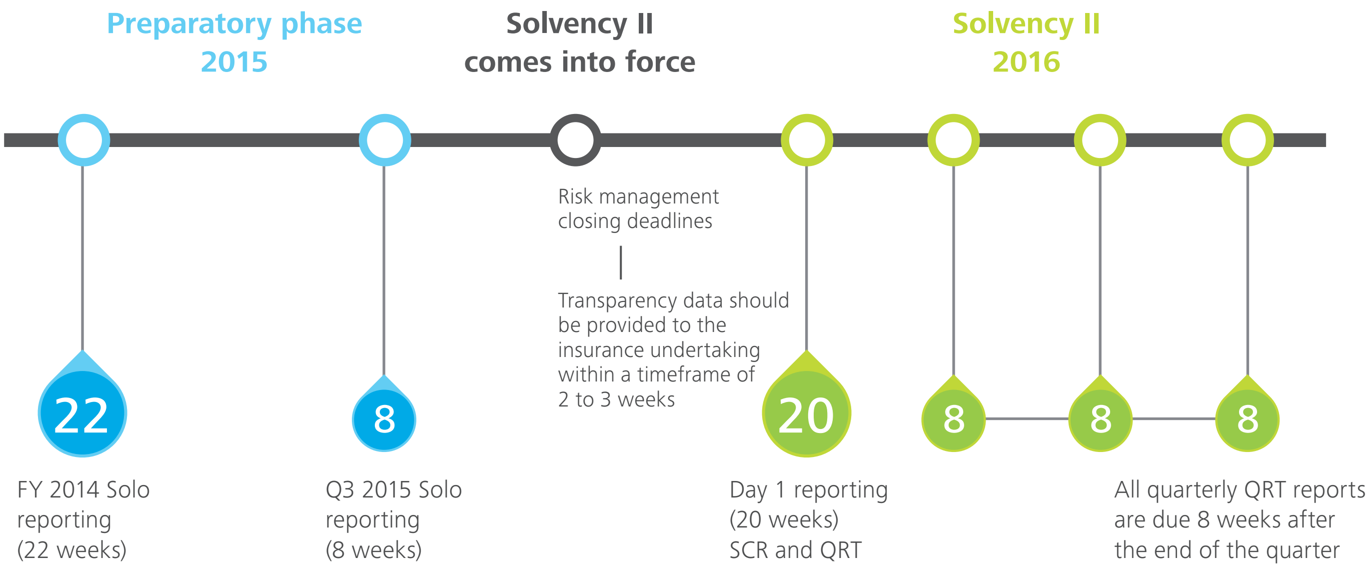


Source: EIOPA Insurance stress test 2014, 28 November 2014, SCR market risk decomposed

Reporting and timeframe

Insurance undertakings will have to provide the first set of Solvency II reports to their home state regulators in May 2016 and on a quarterly and annual basis thereafter (see graph below), with two main elements: Solvency Capital Requirement and the Quantitative Report Template (QRT) on assets and liabilities. Notwithstanding regulatory obligations, some insurance companies may be tempted to estimate their Solvency Capital Requirements on a more frequent basis.

Regulatory reporting timeline within Solvency II

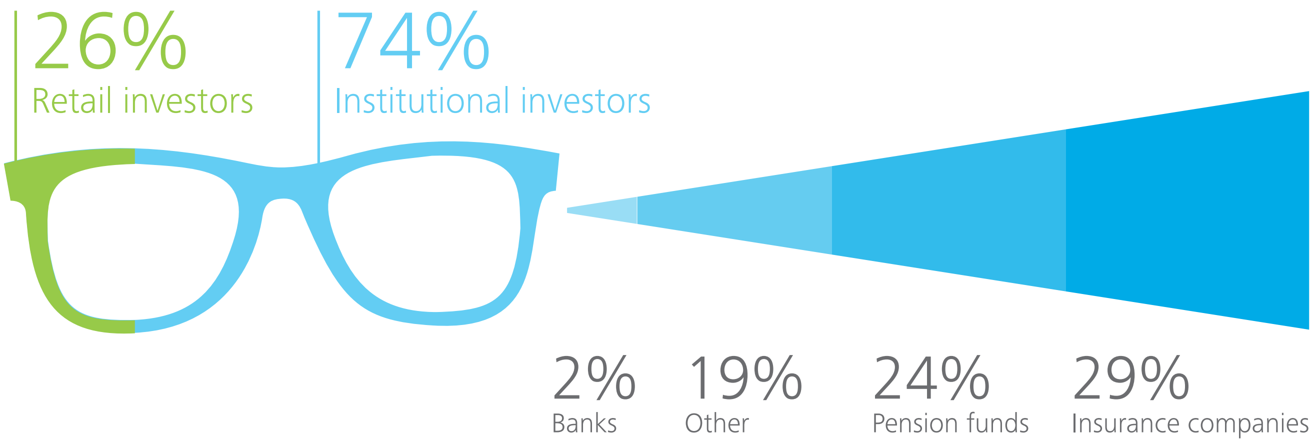


2. Solvency II and the look-through principle will change the way insurance companies work with asset managers

Insurance undertakings are key institutional investors for the asset management industry

Insurers are the largest institutional investors in investment funds, with an overall share in total European AuM of 29 percent, followed by pension funds at 24 percent.

Ownership of European investment funds



Source: Efama, Asset management in Europe, 9th annual review

A recent survey of 56 decision-makers in the German insurance industry shows that 72 percent intend to outsource much of their asset management to external providers following Solvency II. This percentage is even higher for smaller insurance undertakings.

Insurance companies have high expectations of asset managers in terms of reporting and disclosure

One of the main improvements of the Solvency II framework is the requirement to adopt a "look-through" approach in order to obtain an accurate picture of the risks with regard to assets and liabilities As the management of a large proportion of insurance companies' assets (when not all of them) is outsourced to external asset managers through segregated accounts or units of collective investment undertakings, the assistance of the latter will be key in helping the former to perform the required look-through.

The assistance expected from asset managers mainly includes:

- Performance of a full look-through on portfolio investments for market SCR calculation and QRT reporting
- Estimation of risk sensitivities required for SCR calculations at investment or fund level

As the relationship between an insurance undertaking's assets and liabilities must be considered to underpin the market SCR of the insurer, it is not possible for asset managers to pre-compute the market SCR only based on their assets or a proportion of them. Asset managers may only use sub-modules of market SCR as a risk/performance indicator or as an indication of possible matches with specific profiles of an insurer's expected cash-flow obligations.

However, regarding unit-linked products, for which insurance companies do not bear the associated investment risks, market SCR calculated at fund level by asset managers may be used directly by insurance undertakings in their SCR calculations, via the estimated revenue losses under the prescribed market shocks. As a result, insurance companies may look at investment funds' market SCR to compare the regulatory costs associated with them when packaged into unit-linked products. Calculating this risk indicator in compliance with Solvency II rules and the ability to provide appropriate assurance will become additional differentiating factors for the investment fund industry.

Indeed, 83 percent of survey respondents indicated that they had high or very high expectations of asset managers in terms of reporting and disclosure.

Facing rising operating costs and capital requirements, one may also expect insurance/reinsurance undertakings to undergo significant changes in their investment allocation strategies. Among the German insurance companies surveyed, up to 49 percent said they will reduce the number of external asset managers they use.

In conclusion, offering data and analytics reporting to insurance companies will no longer be just a compliance variable but a component in retention and acquisition.

Among the German insurers surveyed, up to 49 percent of respondents said that they will reduce the number of external asset managers they use

Data exchange timeline and frequency

Data and analytics exchanges between fund managers and insurance companies should be expected on a quarterly basis, but annual reporting might be an option for insurance companies that invest less than 30 percent of their portfolio in investment funds.

Insurance companies will submit reports to the supervisory authority four to eight weeks after the end of the quarter, which gives asset managers between one and two weeks to deliver the look-through data required by their insurance undertaking clients.

Among the German insurance undertakings recently surveyed, only 42 percent believe that their main asset manager will be able to submit the vast quantity of data in time.

Challenges associated with importing, enriching, classifying and computing data

One of the challenges associated with Solvency II reporting for asset managers and insurance undertakings is working with data files from different sources with heterogeneous contents and formats. Data harmonization, enrichment of all securities with information from different data vendors, classifications of securities and computational analytics are also challenging.

In terms of data demands for asset managers, up to 100 items need to be collected per investment line from internal and external sources including details of derivatives and structured products that are not readily available. Additionally, appropriate data governance must be implemented to address data licensing and confidentiality issues as well as potential conflicts of interest.

In terms of analytics, between 10 and 50 sensitivities may be necessary to appropriately model a portfolio for SCR calculation purposes. This triggers the issue of portfolio compression and risk clustering if the insurance undertaking prefers not to provide (or receive) analytics and static information at instrument level in order to reduce the pressure on the undertaking's Solvency II system.

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3. Asset managers joining forces to meet Solvency II reporting requirements

To help bridge the gap between data requirements and accessibility, and to encourage a unified approach throughout the industry, associations representing investment management professionals in France (AMPERE, AFG), Germany (BVI) and the UK (IA) have developed a common data exchange template (dubbed the Tripartite Solvency II reporting template or TPT) to support the demands of the Solvency II Directive. The TPT is structured so as to capture data required for Pillar I and Pillar III purposes (SCR calculation and QRT reporting), for which a look-through is expected on asset data.

Identification, optional and control information has also been included. The relevant information categories are as follows:

- Portfolio characteristics and valuation
- Instrument codification
- Valuation and exposure
- Instrument characteristics and analytics
- Transparency
- Indicative contributions to SCR for market risk
- Specific data for convertible bonds
- Specific data in case no reference yield curve is available
- Additional information

An updated 3.0 version of the TPT was released on 13 October 2015 with the support of EFAMA, Austrian, French, Luxembourg, Italian and Dutch fund and asset management associations.

The Tripartite Solvency II reporting template is widely used in France, the United Kingdom and Germany, and in more and more European countries.

Nonetheless, there are still several insurance companies which require a dedicated data format for all information relating to Solvency II, as they are not equipped to handle any other format.

Portfolio compression and data aggregation

One of the major issues for insurance companies pertaining to look-through on investment funds is the large volume of data received from asset managers. This requires significant data management capacities and efficient systems to perform the calculations required under Solvency II. However, insurance companies' Solvency II systems may not be able to handle thousands of portfolios and hundreds of thousands of investment lines, even when the information is presented in a harmonized format.

Some will prefer full disclosure of holdings whereas others will opt for minimal disclosure, and reporting of compressed portfolios structured around a small number of points which mimic the risk implications of the real portfolio. This is done with a view to reducing data processing workload and computation time.

4. Leveraging Solvency II with strategic portfolio considerations and new allocation strategies

While not meeting Insurance undertakings' transparency requests could potentially lead to a loss in market share, the new Solvency II rules mean that there is no guarantee that data reporting alone will suffice to preserve existing market share. Therefore, if not already approached, asset managers are encouraged to engage with their insurance undertaking clients to understand in more details how their investment products may interact with their liabilities and Solvency Capital Requirements. Understanding these dynamics may drive strategic changes for asset managers.

To return to the main underlying principles of the new regulatory regime and some of its strategic goals, one can expect an increasing proportion of insurance companies' assets to be allocated to long-term investments in the real economy targeting in particular SMEs and infrastructure projects, a reduction of complexity and an improvement of asset quality. Asset managers can anticipate these outcomes by structuring infrastructure and private equity funds and reducing the use of complex derivatives, securitizations and structured products.

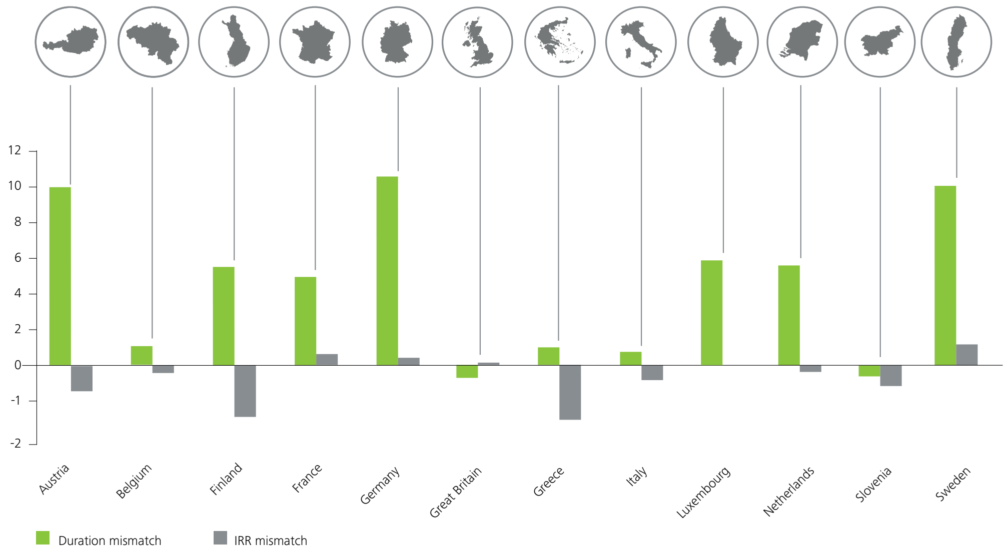
However, certain principles, such as matching the duration of assets and liabilities or matching cash-flows, may require a two-way communication channel to be opened, allowing asset managers to gain additional knowledge on insurance undertakings' specific needs or specific risk exposure and adjust or structure an investment product accordingly. This would result in a reduced solvency capital requirement for the insurance undertaking.

The Tripartite Solvency II reporting template is widely used in France, the United Kingdom and Germany, and in more and more European countries

A recent EIOPA study highlighted the broad duration and return mismatches of assets and liabilities for European insurance companies (see below), and estimated that up to 24 percent of companies would not meet their SCR under a continuation of current low-yield conditions. Long durations on the asset side remain difficult to source, with an average duration of five years for corporate bond investments and eight years for government bond investments held by European insurance companies (source: EIOPA stress test, 2014). High performing assets typically exhibit low duration (for example, this is true of high-yield bonds and corporate loans), or no duration at all (e.g., equities). EIOPA concluded that the continuation of the current low-yield environment could trigger significant issues for insurance companies in meeting promises to policyholders in eight to eleven years.

Insurance companies' ongoing need for asset performance and low Solvency Capital Requirements will require a closer dialogue between Insurers and the asset management industry.

Investment return and duration mismatches for European insurance companies



Source: EIOPA Insurance stress test 2014, 28 November 2014

In a nutshell:

- Solvency II has come into force on 1st January 2016 and insurance undertakings will submit their first regulatory reporting and disclosures in the next months
- Solvency Capital Requirements within Solvency II are based on a "look-through" approach on assets and liabilities and a "delta Net Asset Value" considering several risk factors
- Market Risk is the main driver of Solvency Capital Requirements, and essentially flows from the investment portfolios of insurance companies, very often outsourced to external asset managers
- Regulatory disclosures within Solvency II include a broad range of information on the asset mix of insurance companies and also based on a look-through approach for collective investment funds
- Insurance companies will therefore rely heavily on asset managers for providing them with transparency data and risk information on their investment products and portfolios
- European investment management associations led by the French Club Ampere have developed a common data exchange template (dubbed the Tripartite Solvency II reporting template or TPT) to support the demands of the Solvency II Directive to asset managers
- Beyond portfolio and risk transparency, Solvency II is expected to drive significant changes in the way insurance companies and asset managers work together

Note: mismatches in this table are calculated as the difference between the Internal Rate of Return (IRR) and the durations of liabilities minus those of assets. Therefore a negative mismatch implies higher IRR or duration for assets than for liabilities based on the cash flow reported by the participants to the EIOPA stress test on a country basis.