Preparing for Solvency II
Time for asset managers and asset servicers to act

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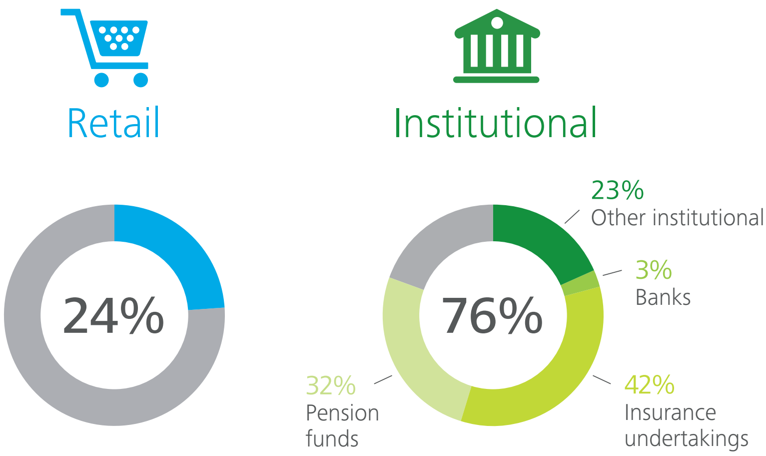
The insurance industry is a significant player in the overall fund sector, accounting for an estimated 42% of the European asset management market.This represents approximately €7 trillion[1] of assets held by an estimated 4,325 insurance and reinsurance undertakings across Europe. Although the incoming Solvency II regulations are not directly applicable to the fund sector, they will impact on Asset Managers and asset servicers (AMs) with insurance sector mandates in two ways. Firstly, considerable efforts will need to be undertaken by the asset management sector to become compliant with insurance-specific portfolio requirements.

Secondly, sound levels of preparation in this regard offer a competitive advantage to those AMs seeking to increase mandate wins from insurance clients. We outline the key areas of focus below.

European asset management industry Total AuM



1 *EFAMA, Asset Management in Europe, Facts and Figures, June 2014, based on total AuM of €16.8 trillion*

Market risk is the largest component or module (more than 50%) of the standard Solvency Capital Requirement (SCR) formula

Solvency II—time is running out

Solvency II rules enter into force on 1 January 2016, with the objective of implementing common solvency requirements that better reflect the risks that insurers face, while at the same time delivering a consistent supervisory system across all EU member states. The new system is intended to offer insurance undertakings a greater incentive to measure and manage their risk situation more effectively, for example through lower capital requirements and lower pricing. It is the most important regulatory change impacting the insurance industry for a number of decades.

In order to ensure market readiness, the European Insurance and Occupational Pensions Authority (EIOPA) issued guidelines for National Competent Authorities (NCAs) on how to proceed in the period leading up to the application of the directive. Most EU NCAs have made a commitment to apply those guidelines. The guidelines require insurance undertakings to perform calculations and submit quantitative information relating to the 2014 financial year.

Solvency II is built on three pillars that govern the solvency requirement and approach:

- *Pillar 1* considers the quantitative requirements of the system, including the calculation of technical provisions, the rules relating to the calculation of solvency capital requirements and investment management. Market risk is the largest component or module (more than 50%) of the standard Solvency Capital Requirement (SCR) formula. The main elements of this module are equity, spread and interest rate risk, although the relative importance of the sub-modules varies widely according to the type of insurance undertaking
- *Pillar 2* deals with the qualitative aspects of an insurer’s internal controls, risk management process and defines its risk appetite framework
- *Pillar 3* is concerned with enhancing disclosure requirements in order to increase market transparency and ease comparability

New product development

Investment funds currently represent around 29% of the total financial assets on the insurance balance sheet, and the capital requirements imposed by Solvency II will change the insurer's asset allocation. The insurance industry is now in the market for new asset management products that better reflect their incoming obligations and match their specific risk management framework.

To offer the products required by the insurance sector, AMs will have to consider the cost of capital of each type of investment and whether the cash flow matches the insurer's cash flow obligations. The investment strategy must take account of the fact that the SCR calculation is based on the Delta NAV approach, which requires modelling techniques to capture the interaction between the insurer's assets and liabilities. The SCR ratio calculated by the AM will not reflect the liability impact, and can therefore only be used by insurers as a risk/performance indicator.

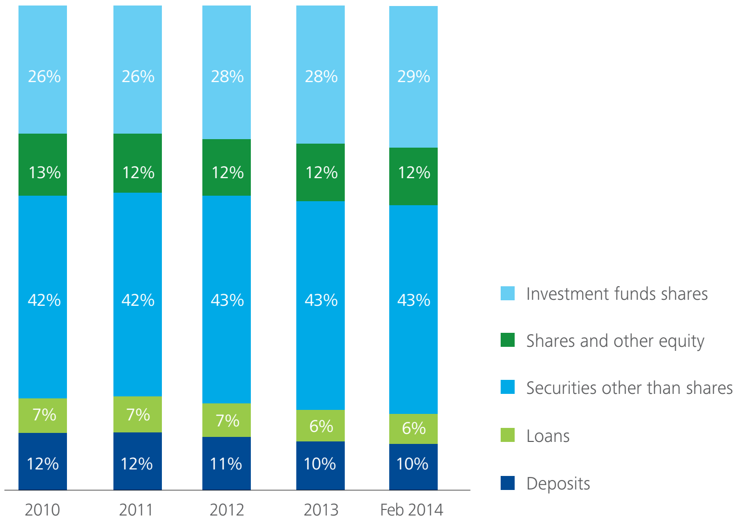
With this new regulation, AMs will have the opportunity to design tailored products that will secure and potentially increase the share of insurance undertakings in their institutional client portfolios.

Reporting

In order to properly assess the market risk inherent in collective investment undertakings and other investments packaged as funds, more granular information will be necessary. Insurance sector clients will be expecting a look-through approach to the underlying assets, since this is required for the Quantitative Reporting Template (QRT), as well as the SCR calculation.

Structure life insurer's investment portfolio

Euro area



Where the look-through approach cannot be applied to collective investment undertakings or investments packaged as funds, the SCR may be calculated on the basis of the target underlying asset allocation. However, this is dependent on the target allocation being available to the undertaking at the level of granularity necessary for calculating the Solvency Capital Requirement, and on the underlying assets being managed strictly according to this target allocation.

Where this approach is not possible, and for all collective investments to which the look-through approach cannot be applied, the type 2 equity charge (largest impact) should be applied. In this situation, however, insurance undertakings must provide an explanation to the regulator as to why the other approaches were not taken.

Insurance sector clients will be expecting a look-through approach to the underlying assets, since this is required for the Quantitative Reporting Template (QRT), as well as the SCR calculation

AMs must also align their agendas with those of their insurance client's risk management closing calendars (generally between three to six weeks after the closing date for quarterly evaluations). Some insurance undertakings are already in contact with their AM in order to define the content and format of the new reporting, while some initiatives at a national market level are currently defining a standard data request or a target reporting platform.

AMs should also be aware that these data requests have a number of implications for confidentiality (for example, the AM's investment strategy), fair treatment of different categories of investor (institutional and retail) and the transmission of data purchased under agreement from financial data providers.

Governance

Three particular areas of governance should be considered by AMs: data governance, mandates and the prudent person principle.

Data governance

Under Solvency II, AMs will become data providers. Data provided by AMs will be used by insurance undertakings to calculate the SCR and for disclosure purposes. Insurance undertakings are likely to implement data quality control procedures to identify deficiencies and to measure, monitor, manage and document their data quality. Deficiencies in data quality could affect business relationships with AMs.

Asset management mandate

Insurers must perform a detailed review of the service provider's ability to deliver the required functions. A written agreement (such as a Service Level Agreement) with the service provider that clearly allocates the respective rights and obligations of each party, including data governance aspects, will be expected. The service provider will also need to have an adequate risk management and internal control system in place.

Prudent person principle

While Solvency II does not implement any investment restrictions, it does not mean that undertakings can take investment decisions without considering whether they are prudent and in the interest of policyholders. AMs should only invest in assets for which the risks can properly be identified, measured, monitored, managed, controlled and reported.

The requirements of Solvency II extensively cover the main aspects of the prudent person principle, such as asset-liability management, investment in derivatives, liquidity risk management and concentration risk management. The more familiar AMs are with these requirements, the more flexibility they will be able to bring to their portfolio management.

Conclusion

Readiness in the asset management market for Solvency II varies widely. While France, Germany and the United Kingdom have adopted a common approach, many other countries are some way behind. A thorough knowledge of Solvency II requirements stands to become the defining feature of AMs seeking to retain or expand their portfolio of insurance clients in the future. Given the short time left prior to the new regime entering into force, insurers are likely to begin challenging their AM to provide comprehensive details. AMs will have to work hard to introduce and test new business processes well in advance of the January 2016 deadline to ensure a smooth transition. However, investments made now by willing firms can position them favourably for future growth opportunities in the insurance sector.

To the **point**:

- The new regulatory regime for the European insurance/reinsurance industry, Solvency II, will enter into force on 1 January 2016
- This regime provides a risk-based framework for supervision, in addition to strengthening governance
- Market risk is the largest component of the standard Solvency Capital Requirement formula
- A key issue related to market risk is the application of the look-through approach, particularly for unit-linked business and structured products
- The look-through approach is a real challenge for the insurance industry in terms of calculation and reporting
- The prudent person principle requires insurers to show that their investment strategy matches the interests of policyholders, thereby modifying the relationship between (re)insurers and their AMs