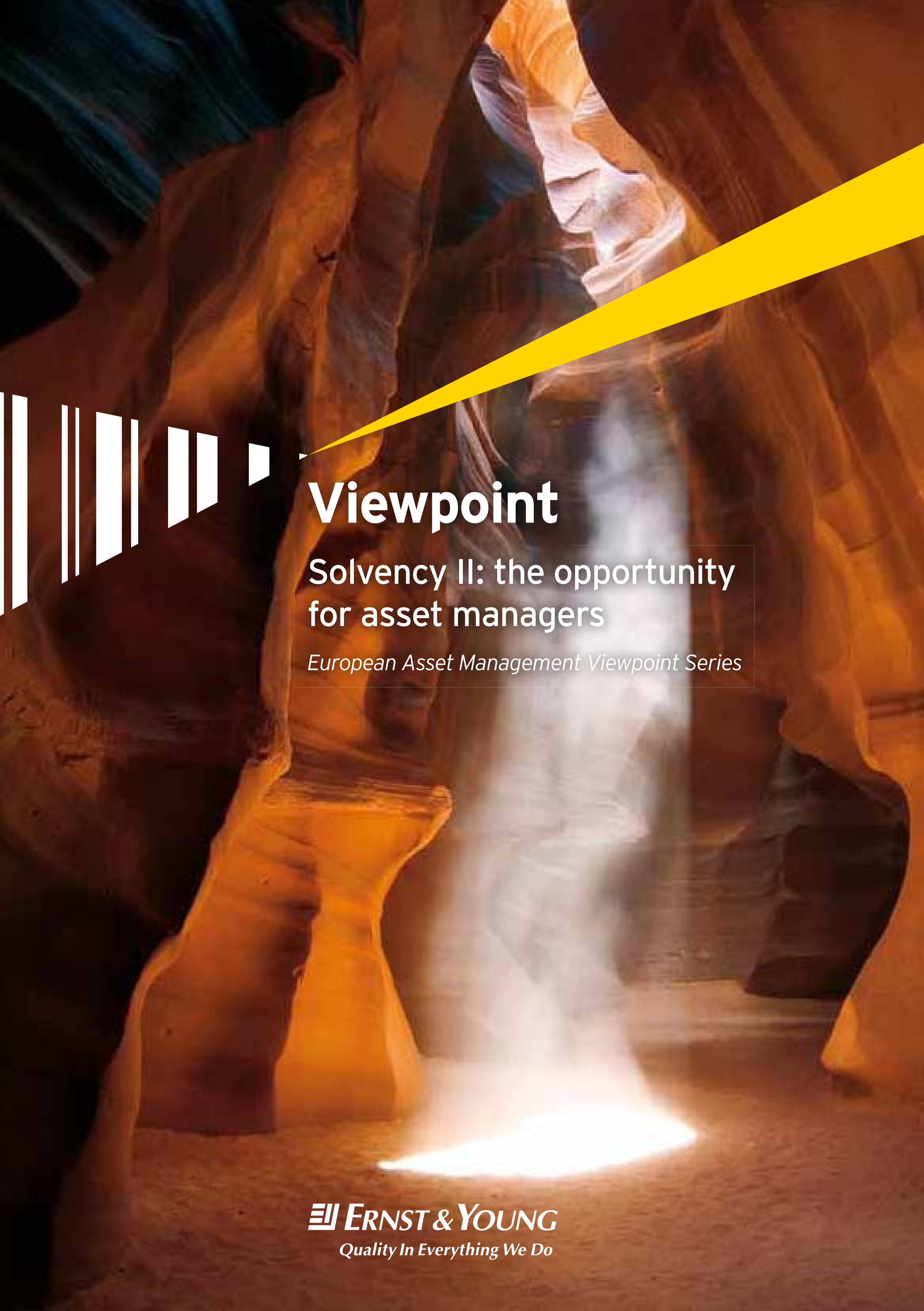

Viewpoint

Solvency II: the opportunity for asset managers

European Asset Management Viewpoint Series

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Solvency II: the opportunity for asset managers

This paper examines the potential impact of Solvency II on asset managers managing insurance portfolios. It sets out some of the implications of the new regime for investment decisions, especially in terms of balance sheet management, and some potential capital market effects. It also suggests some areas where asset managers could develop their products and services to meet insurers' changing requirements. We summarize with a call for asset managers to be ready for the changes Solvency II will make to their business models.

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Solvency II will have a huge impact on European insurers — and their asset managers

When it comes into force at the start of 2013, Solvency II will revolutionize the prudential regulation of European insurers. The regime will establish a new approach to the measurement and management of risk and capital, and will break new ground in terms of the influence that regulation wields over insurance business models and strategy.

It has become a cliché to say that Solvency II represents the most wide-ranging regulatory reform that the European insurance industry has seen, but there is far less awareness of its potential effect on asset managers. In our previous Viewpoint, *The impact of Solvency II on asset managers*, we discussed the impact that Solvency II's requirements for complete, accurate and timely data will have on firms managing insurers' asset portfolios. In this paper, we consider how the new regime will affect insurers' investment decisions and, by extension, asset managers' businesses.

"The regime will establish a new approach to the measurement and management of risk and capital"

The new regime will fundamentally alter insurers' investment decision-making

"Solvency II introduces significant balance sheet and capital volatility through the use of mark-to-market approaches"

The requirements of Solvency II have not yet been finalized, and will need to be transposed into detailed rules by national supervisors across Europe. Even so, the direction of travel is clear. In general terms, Solvency II sets out several expectations for insurers' investment management activities. Firstly, the new framework will apply differential capital charges to insurers based on the actual financial risks they run, allowing firms to manage their capital requirements in line with their risk appetite more actively than before.

Secondly, the new rules also encourage diversification of investments, by applying additional capital charges for different levels of concentration risk. Thirdly, and most of all, Solvency II introduces significant balance sheet and capital volatility through the use of mark-to-market approaches, and insurers are looking for ways to manage this volatility appropriately.

Capital charges are being levied on different asset classes

From an asset management perspective, the specific proposals for capital charges on key asset classes will be a particularly important aspect of Solvency II and could lead to significant changes in investment behavior.

Interest rate and foreign exchange (FX) risk will now attract explicit charges based on the level of mismatch between assets and liabilities. Since the expected return on these risks is typically lower than equity and credit, we anticipate companies to take steps to minimize their exposure to interest rate and FX risk.

Corporate bonds, a staple of insurer investment portfolios in the past, will now attract material capital charges based on credit quality and duration, discouraging companies from taking on high levels of credit risk or longer-dated credit risk. The recent increased buying activity of insurers in the covered bond market reflects these changes.

Real estate will attract a flat charge of 25% based on the observed volatility of traded real estate funds. Some direct real estate investors may consider this high, given the different risk profile of direct investment (lack of leverage, liquidity considerations and stability of rental yields).

Equities, typically seen as a source of long-term investment return, will now attract a significant capital charge (39% in the base case for Global Equity). This will discourage companies from investing in equities. In addition, under the current proposals, equity investments will be divided into Global and Other. Shares listed in the European Economic Area or other Organization for Economic Cooperation and Development (OECD) countries will fall into the Global category, while non-OECD and non-listed equity will be categorized as Other Equity. This Other Equity category includes all manner of alternative investments, such as hedge funds and private equity, and attracts a 10% higher charge than Global Equity (offset by some diversification allowance). Given the 49% charge, this means that there is likely to be significant pressure on alternative investments as an asset class.

In a measure designed to reduce procyclicality, a 'symmetric adjustment' to the capital charge has been introduced. At times of equity market stress, this would potentially reduce the capital charge to 30% for Global Equity and 40% for Other Equity. In contrast, this mechanism would work in the opposite direction during boom periods, increasing the charge to levels of up to 49% and 59%, respectively.

Another key area of interest for asset managers is the new regime's focus on investment transparency. The current proposals levy heavy capital charges on asset portfolios that do not allow a clear 'look through' to underlying assets. A range of assets including collective investment funds, mutual funds, structured credit products and non-segregated mandates, will need to be assessed on the basis of their underlying exposure to each of Solvency II's market risk categories. Where this is not possible, investments will be classed as Other Equity, attracting a heavy capital charge.

> "There is likely to be significant pressure on alternative investments as an asset class"

Could the proposed changes prompt strategic repositioning of the equity and corporate bond markets?

Solvency II's proposed risk-based capital requirements and use of risk-free discount rates have not only generated discussion within the insurance industry, but also across the wider capital markets. Solvency II could lead to significant changes in insurers' bond holdings, which typically make up the majority of asset portfolios. Under the new rules, long-dated corporate bonds will attract a significant capital charge for spread risk based on rating and duration. This may lead to a shortening of credit investment or, more drastically, a move to higher-rated sovereign debt.

The proposed regulations give a zero spread weighting to all AAA/AA-rated sovereign debt, so insurers could be tempted to reduce their holdings of long-term corporate debt in favor of sovereign bonds.[1] At a time when many European governments are attempting to reduce their levels of borrowing, but corporate balance sheets are in comparatively good health, such a shift could appear counter-intuitive.

In addition, the threat of heavier capital charges for equity investments, at a time when mark-to-market accounting is becoming more widespread, has led some commentators to warn of the potential impact of a sell-off by insurers.[2] This could lead not only to significant movement in the equity markets, but also to reduced availability of capital for corporate borrowers. European regulators' steps to reduce the procyclicality of equity capital charges appear to be aimed at keeping the asset class attractive to insurers, but it remains to be seen whether these moves will be effective.

> "It seems likely that insurers will still find it hard to absorb the short-term volatility of equity investments under the new regime"

[1] "Pensions favour emerging debt over developed". Financial Times, 23 January 2011.
[2] "Insurers gear up for new charges". Financial Times, 30 January 2011.

Solvency II throws up strategic challenges for insurers; asset managers need to be ready to respond

By changing the way they manage their balance sheets, Solvency II will go to the heart of how insurers operate. The new capital charges will encourage investment functions to use asset allocation as a means of optimizing their use of capital, and will require them to build closer links with the risk and actuarial functions.

Insurers remain under pressure from investors and policyholders to deliver attractive returns. Failure to do so will make it much harder to win business and raise capital. However, insurers will come under supervisory pressure to reduce exposure to higher yielding, more capital-intensive assets. These conflicting aims need to be managed via a dynamic asset liability management system to maintain optimum allocation as conditions change.

Solvency II will force insurers to adapt their approach to asset liability management. This, in turn, may prompt many to review the mandates they have awarded to asset managers and to put existing and new relationships under closer scrutiny. The key question, therefore, is: are asset managers ready to respond?

Asset managers need to help insurance clients manage their balance sheets in innovative ways

In response to this scrutiny, asset managers will need to be able to offer their insurance clients products and services that address their altered requirements. We see several areas where asset managers, hoping to take advantage of the coming shake-up, are beginning to develop new capabilities.

One area is the management of insurers' balance sheet volatility. The new capital charges penalize duration mismatch between assets and liabilities, even from investments in relatively safe government bonds. Going forward, a number of insurers (particularly those that are capital constrained) are more likely to prefer investments that provide closer matching with their liabilities and avoid risky asset classes. At its most basic, this might involve switching from equities to sovereign debt. However, this could also lead to increased demand for bespoke products to hedge long-duration liabilities, or products that match the complex discount rates the new regime will use. Products that offer some form of hedge against changes in the value of financial guarantees, embedded in the insurance contracts, will also be highly appreciated by insurers.

A second area where asset managers are beginning to develop their capabilities is portfolio construction. Insurers will need to maximize risk-adjusted returns and optimize their use of capital. At the simplest level — as already discussed — this may involve minimizing interest rate and FX mismatch; reducing holdings of equities, long-term corporate debt and structured credit, while boosting exposure to short-dated corporate bonds and longer-dated sovereign debt. On its own though, this does not add up to an investment strategy. Long-duration government bonds are the most capital-efficient option, but many insurers will simply not be able to give up the expected investment return from risky assets and still meet their obligations to policyholders. Asset managers need to pay more attention to their insurance clients' liabilities and offer genuine portfolio optimization solutions, which allow insurers to target an 'efficient frontier' of maximized return within their risk tolerance.

One aspect of such a strategy will be improving the level of genuine portfolio diversification that should not evaporate at times of stress (going beyond simply low correlation investments). We would expect firms to explore the potential of new and alternative asset classes such as commodities, infrastructure or convertible bonds. Property exposure – especially if achieved indirectly via property lending – could also prove to be more capital efficient than equity investment. In addition, investment mandates may become less constrained due to the removal of asset admissibility restrictions in some countries, opening the way for asset managers to make greater use of swaps and other derivatives.

> “Products that offer some form of hedge against changes in the value of financial guarantees, embedded in the insurance contracts, will also be highly appreciated by insurers“

Asset managers should be ready to take advantage of new modeling techniques

Asset managers, hoping to generate value for insurance clients implementing Solvency II, need to develop a deeper understanding of the new regime's portfolio optimization requirements. This is leading a number of asset managers to explore the use of insurance company risk capital models to understand an insurer's risk profile. Models based on replicating portfolios are becoming a standard in the insurance industry, as they can capture the interaction of assets and liabilities, measure the resulting diversification benefits and enhance the responsiveness of asset liability management.

As a result, they provide the basis for an asset manager to test the impact of new, tailored products, which optimize the full balance sheet of an insurer rather than just an individual asset class. With the right tools, it is relatively simple to build a replicating portfolio model office of an insurance company's balance sheet, and this model office can provide a testing ground for assessing the Solvency II capital impacts of new or existing products.

> "Solvency II is leading a number of asset managers to explore the use of insurance company risk capital models to understand an insurer's risk profile"

Summary: asset managers should give urgent thought to the implications of Solvency II on their business

Our paper shows that companies are facing an environment of change prior to the implementation of the Solvency II regime. The new regime will fundamentally alter insurers' investment decision-making, well before it comes into effect.

With various levels of capital charges being levied by the Solvency II regime on different asset classes, we expect to see strategic repositioning by insurers within the equity and bond markets. It will be for each asset manager to decide how they respond to these investment decisions faced by their existing insurance clients, as well as potential future clients.

Solvency II is a textbook example of how regulatory change within one industry can have indirect implications on an entirely separate industry, and we would encourage asset management firms to prepare accordingly. We feel that many asset managers could be doing more to anticipate the needs of their insurance clients, and Solvency II is piece of regulation that the asset management industry cannot afford to ignore.

Contact

To discuss the issues raised in this Viewpoint, please contact one of our advisors below; they will be happy to help.

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