

A new approach for Insurers and asset managers under solvency II

Executive Summary

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After many years of heated debate, delays and multiple iterations, Solvency II finally came into effect on 1 January 2016. This EU directive determines the capital requirements for insurers and for many will cause a seismic shift in how they run their business. Although the regulations are now live, their full impact has yet to be felt. Consolidation is anticipated as well as fundamental changes to business models and products which are no longer appealing under Solvency II.

Solvency II requires a fundamental rethink of how insurers and asset managers work together. We believe that insurers can increase capital efficiency by working with asset managers who have a deep understanding of Solvency II, to improve liability matching and target a return-seeking active overlay. Using a segregated mandate rather than pooled vehicles helps to align further the insurer and asset manager and can provide accurate and timely data for 'look through' assessments.

In this piece we propose a better way for insurers to manage assets – an approach in which assets are managed relative to liabilities with an active overlay, and are risk controlled through a well designed mandate. This approach is particularly appealing for insurers with guarantees to meet as it allows a return to be targeted while also matching liabilities and keeping capital charges low. Clearly this relies on the ability of the active manager to meet or exceed targeted returns, however the alternatives, either raising capital or consolidation, are likely to be unappealing.

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Asset managers face specific demands from insurers related to Solvency II

After many years of heated debate, delays and multiple iterations, Solvency II finally came into effect on 1 January 2016. This EU directive determines the capital requirements for insurers and for many will cause a seismic shift in how they run their business. Although the regulations are now live, their full impact has yet to be felt. Consolidation is anticipated as well as fundamental changes to business models and products which are no longer appealing under Solvency II.

A lot of attention has been paid to the treatment of liabilities, with insurers building teams and technology to meet the requirements of Solvency II. There has been less attention on the treatment and management of assets. It is clear that asset managers also need to change if they wish to continue to service EU insurance clients.

Asset management is dominated by products which have a primary aim of outperforming a specified benchmark. Under Solvency II, insurers are required to apply a 1 in 200 year stress to both assets and liabilities, and this determines the capital that they are required to hold. At a minimum, asset managers need to provide large amounts of data to allow the insurer to incorporate these assets into their overall calculations. However this approach has a number of shortcomings:

- Data is not always detailed or timely enough.
- The choice of assets impacts the insurer's capital charge.
- Assets tend to be managed to narrow objectives against standard benchmarks.
- Longer-term liabilities are sensitive to changes in the market credit and swap spread elements of the discount curve, which has implications for risk and performance of assets.
- Insurers need to find a balance between Solvency II, accounting requirements and their own risk assessment.

Historically many insurers, particularly in continental Europe, have offered guaranteed products and used a large allocation to equities to meet these obligations. Unfortunately this model no longer works under Solvency II because equities attract a high capital charge.

Switching to bonds reduces the capital required but may not produce the returns required to meet legacy guarantees. Although Solvency II allows transitional measures to smooth the impact of this change, this reduces each year requiring the insurer to produce an excess return while keeping capital charges low.

Liability matching with an active overlay can improve an insurers capital position and risk adjusted returns

Solvency II requires a fundamental rethink of how insurance assets are managed by third party managers. Rather than thinking in terms of a benchmark and a return above this, we believe that asset managers need to consider assets and liabilities together. The liabilities are the benchmark and returns in excess of liabilities should be considered relative to a capital charge. We think this approach helps insurers to set up their balance sheet in a way that is transparent and clearly articulated to stakeholders.

We believe that insurers can make efficient use of capital and meet the requirements of Solvency II by:

1. Treating liabilities as the benchmark
2. Matching liabilities using key rate durations
3. Choosing assets with a high expected return relative to the capital requirements
4. Targeting an excess return using an actively managed overlay

Asset liability matching traditionally attempted to match actual cash flows. However, it is generally not possible to do this exactly and, in any event, we think it is unnecessary. We believe that the best approach is to use key rate durations, which measure the duration at specific maturity points along the curve. Key rate durations provide an accurate model of the cash flows, which will converge to cash flow matching as the number of key rates used increases. This approach also allows consideration of twist and butterfly exposures which are not directly stressed under Solvency II, but should be part of the risk assessment and included in the mandate parameters for controlling risk.

Having established the cash flows, insurers will often seek to match liabilities using a credit portfolio with limited investment freedoms, and invest the surplus funds in higher risk, zero duration assets (for example private equity, real estate or absolute return funds). For a portfolio of fixed income assets we see no benefit in investing in a credit portfolio to match liabilities and then having an allocation of surplus funds to an absolute return bond fund or macro hedge fund.

It is possible to create a flexible mandate with a well-defined set of parameters to control risk which permits the investment manager to provide an active overlay on the assets held to match the liabilities. The manager will typically hold high quality assets as part of the liability matching strategy which can be used for collateral for the active overlay. Active trades similar to those used in absolute return fixed income strategies can be used to express views in rates, foreign exchange, credit or inflation to generate an active return. We believe that combining liability matching with an active overlay provides more efficient use of capital than a silo approach using pooled vehicles.

Insurers are also required to add a risk margin to the value of their liabilities – this is effectively part of the liabilities and is sensitive to interest rates. Under our proposed approach this can be added to the liabilities and hedged.

Treating liabilities as a benchmark requires a number of other considerations. Risk models need to reflect the appropriate Solvency II discount curve and related risk factors (for example the volatility or matching adjustment, as appropriate). Performance attribution should also reflect the key factors driving both assets and liabilities. Reporting risk and performance in a consistent way across both assets and liabilities encourages the asset manager to take a holistic view rather than treating the assets in isolation. In this framework the regular performance updates and risk discussions are more beneficial to the insurer as they will be more closely aligned to the operation of their business. For example, the unwanted volatility arising from the volatility adjustment can be better understood and managed using this approach.

Asset managers with a deep understanding of Solvency II can collaborate with insurers to help them increase capital efficiency

To apply the approach above requires asset managers to have a firm grasp of Solvency II. Although the standard formulae calculations are straightforward, some of the classifications used are not. For example::

- Should a security receive treatment as a bond or a securitisation?
- Is the asset appropriate for a matching adjustment portfolio?
- Does a hedge qualify for risk mitigation treatment?

It is also important to understand the liabilities being hedged and how they are affected by changes to the volatility or matching adjustment. If we consider credit in constructing an optimal Solvency II portfolio, then the first step might be to choose bonds that provide the highest spread. This spread should be reduced to allow for an estimate of the probability of default and the cost of downgrade, and we can use the calculations provided by EIOPA for the volatility adjustment as a starting point. The results are shown in table 1, and highlight the more attractive sectors as lower rated single A or BBB bonds, with financials offering a slight edge relative to non-financials.

Table 1: Impaired Spread

Bucket	<3y	3-5y	5-7y	7-10y	10-15y	>15y
Financials						
AAA		30				20
AA1						22
AA2	52	62	51	69	58	89
AA3	55	68	73		83	98
A1	35	46	37	81		71
A2	91	64	97	117	121	111
A3	134	61	173	121	183	151
BAA1	36	73	195	174	142	185
BAA2	49	127	164	212	229	221
BAA3	104	92	282	369	265	241
Non-Financials						
AAA	45	39	43	45	36	27
AA1	22	-1	-25	-13	-4	-15
AA2	48	59	47	73	55	55
AA3	78	57	70		60	76
A1	51	62	55	75	72	40
A2	72	71	56	120	103	99
A3	94	76	81	92	85	64
BAA1	64	83	116	96	94	93
BAA2	91	101	119	171	143	106
BAA3	169	184	215	215	204	260

Table 2: Return On Capital

Bucket	<3y	3-5y	5-7y	7-10y	10-15y	>15y
Financials						
AAA		7%				2%
AA1						2%
AA2	28%	15%	9%	11%	7%	8%
AA3	28%	17%	13%		10%	9%
A1	12%	9%	5%	10%		5%
A2	38%	13%	14%	14%	12%	9%
A3	44%	12%	26%	14%	19%	13%
BAA1	5%	9%	16%	11%	8%	8%
BAA2	11%	15%	13%	14%	13%	10%
BAA3	27%	9%	23%	23%	25%	12%
Non-Financials						
AAA	28%	11%	9%	8%	5%	3%
AA1	9%	0%	-4%	-2%	-1%	-1%
AA2	26%	15%	8%	11%	6%	5%
AA3	40%	13%	12%		7%	7%
A1	23%	12%	8%	8%	7%	3%
A2	31%	14%	8%	14%	10%	8%
A3	37%	15%	11%	11%	8%	6%
BAA1	15%	10%	9%	6%	5%	4%
BAA2	18%	12%	9%	11%	8%	5%
BAA3	38%	21%	17%	14%	11%	11%

However, this analysis fails to consider capital charges. Table 2 considers this impaired spread relative to the capital charge for spread risk and highlights the attraction of shorter dated bonds. Higher rated bonds also fare better due to lower capital charges.

Segregated, well designed mandates provide accurate and timely data for look through and help to align the insurer and asset manager

Solvency II requires insurers to look through to the assets in an investment vehicle to assess their capital requirement. However many have found it hard to get enough information to identify and model more complex securities, and there is often a lag in receiving the data. Although Solvency II may allow lagged data to be used and only requires quarterly reporting, ideally insurers should have much more frequent and accurate updates across their whole balance sheet. To enable this we advocate managing assets using segregated mandates rather than pooled vehicles: a segregated mandate allows full transparency of assets and the systems for reporting to be used on a timely and accurate basis.

The mandate should build in controls that align the interests of the insurer and the asset manager. The capital attracted by the assets is clearly one key parameter to incorporate into the mandate, and a VAR number using a standard risk assessment, or measures related to accounting treatment may also be included. This also facilitates the active overlay approach that we advocate above by allowing efficient use of collateral and use of the insurers own derivative documentation.

The insurer and asset manager may also wish to address how new business and cash is managed to meet liabilities as they fall due. This may also be formalised through the mandate, and is another example of how the interests of the insurer and asset manager may be aligned more closely. The treatment of surplus funds could also be agreed – for example these could have the active overlay applied and be managed relative to a LIBOR benchmark, reducing flows related to profit or loss, and consequently costs.

Rather than the mandate being a fairly static document, it can be reviewed regularly and allow the insurer to work with the asset manager to control key risk parameters based on their business requirements. For example, Solvency II provides diversification benefits in the calculation of the capital charge and the insurer may want to adjust their risk appetite on the asset side in order to optimise their overall capital charge.

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