A glass half full

For asset managers willing to make their products attractive to a market coming to terms with Solvency II, the potential rewards are huge

Among the swathe of new regulations assailing the alternative investment fund industry, one piece of the puzzle has attracted relatively little attention. The Solvency II Directive presents huge challenges for the European insurance industry, changing the basis of regulatory capital calculations while dramatically increasing reporting and governance demands. The knock-on effect for asset managers will be considerable and, as the practical details of the new rules start to emerge, it is becoming apparent that few managers will emerge completely unscathed.

The complexity and scope of Solvency II have led to two commencement date deferrals, with a third now being considered. This perhaps goes some way in explaining the investment fund industry's perceived indifference. But as the implementation date of January 2014 rolls into view, it is clear that managers who continue to ignore its implications do so at their peril. Not only are such managers likely to jeopardise both their direct and indirect relationships with insurance companies, they could also be missing out on a huge opportunity to raise additional assets.

The Directive is built around three pillars: pillar 1 lays down quantitative requirements around measurement of assets, liabilities and capital; pillar 2 sets out expectations with regard to internal governance, risk management and solvency assessment; and pillar 3 details disclosure and transparency requirements, including reporting to regulators.

> "Few managers will emerge completely unscathed"

Challenges under the new rules

Solvency II will have a dramatic impact on asset managers' relationships with their insurance company clients, primarily with regard to asset allocation and data management and provision.

Asset allocation

The Directive introduces for the first time at a Europe-wide level a risk-based approach to insurance companies' regulatory capital requirements. Different capital charges are allocated against asset classes to reflect their varying ability to withstand market stresses, as tested against specific scenarios. What initially grabbed attention – and caused indignation – in the asset management industry is that investments in hedge funds, which fall within the 'other equity' category, are subject to a particularly high capital charge. Initial reaction has now given way to a more general realisation that the new capital charges are bound to force insurance companies to reconsider their asset allocation strategies on risk/reward principles.

Asset managers will need to fully engage with their insurance company clients, assisting them in gaining a full understanding of the risks inherent in their portfolios and the risk-adjusted returns of relevant products. This will likely mean more extensive risk analysis, portfolio breakdowns and scenario stress-testing. As the capital charges are not fixed, but rather can vary within a certain range, there is also likely to be an added emphasis on active management of insurance company assets, moving away from long-term buy-and-hold. Insurers will need to introduce more active allocation policies to reduce volatility in their solvency ratios (as capital charges move around). They will also have to ensure they are invested in capital-intensive products at the most effective times, making continuing determinations about how to spend their risk capital in the prevailing market environment. As well as scenarios where de-risking will be appropriate, this could lead to an increased appetite for risk in certain circumstances. For example, when insurers may take an aggressive view of the risk/reward analysis of a particular asset class in light of relative capital charges across asset classes.

The new emphasis on risk analysis and active management will also place additional scrutiny on portfolio liquidity, with insurers needing to be confident of the liquidity terms of their own investments as well as the liquidity profile of underlying positions. Managers will likely be expected to provide analysis of timelines for the realisation of the different portions of a portfolio.

Data management and provision

The most prominent theme of the Solvency II text is an increased emphasis on the quality, reliability, detail and speed of provision of the data used by insurance companies to underpin their compliance with the Directive's requirements. Time and again across all three pillars this theme emerges, from the introduction of complementary identification codes (according to which all assets are to be categorised), to compressed deadlines prior to which reports must be filed with regulators. Insurers will be required to demonstrate that they have assessed and quality tested the data upon which they are relying for Solvency II purposes. Crucially, what's categorised as 'external' data (that provided by third parties) is to be held to the same standards.

The data-focused demands on asset managers to enable their insurance clients to comply with Solvency II will lead, at the very least, to significant changes in data provision practices, and in all likelihood, an entirely new approach. Insurers will likely have no more than six weeks to provide regulators with quarter-end reports and will also need to run internal reporting cycles on at least a monthly basis. Managers will need to be able to support these reporting requirements by providing accurate and up-to-date information on extremely short timescales.

This pressured timeline coupled with the granularity of data needed (security-by-security assessment pursuant to the complementary identification codes) and the quality assurance requirements mean an automated process that is constantly monitored and quality-checked appears to be the only option to service insurer's Solvency II needs. Further, to avoid the highest capital charges and to be able to gain as full a picture as possible of investment risk, insurers will need to be able to look through investment structures to identify and categorise ultimate

underlying assets. This requirement will be of particular concern to funds-of-funds, but even on a general level, it is clear that data transmission between asset managers will need to be enhanced on an industry-wide level.

The opportunity

Insurance companies account for approximately 5% of global hedge fund assets under management, with investment in hedge funds seen as a valuable method of maximising investment returns and diversifying risk. Taking the necessary steps to enable insurance clients to comply with Solvency II will be difficult, time-consuming and expensive for managers. However, those that are prepared to surmount these challenges and are able to demonstrate compliance will automatically establish themselves as the first and only port of call for insurance company assets.

> **"Segregated managed accounts will proliferate as the product of choice"**

Asset managers who do not have the relevant capabilities and processes in place will simply not be able to manage European insurance company assets and, as insurers review their relationships in the light of the new rules, there are likely to be significant opportunities for well-positioned managers in the sector. Given the look-through requirements referred to above, any manager with a link to an insurance company anywhere in its chain of clients (particularly via a fund-of-funds investor) will find itself subject to look-through requests and the willingness to provide such information will become a significant factor in diligence requests at all levels.

Insurers are moving to consolidate their adviser panels around those that provide the best Solvency II-compliant service. Managers prepared to engage with insurance companies to understand their requirements, and provide customised and sophisticated analytics and reporting, are likely to be rewarded by an ingrained, longer-term relationship more akin to a strategic partnership than the standard investor/manager relationship assessed on a rolling three-year basis.

Some first steps

Managers with existing insurance company clients should be working with them to obtain a good understanding of what will be expected of each party under the new rules. Once the practical requirements are fully understood, managers will need to demonstrate an offering which combines strategy, detail and, most importantly, a viable process to enable insurers to comply with their obligations. Managers wanting to break into this market should be reviewing their products and processes to determine how best to position themselves in a post-Solvency II world.

It seems inevitable that segregated managed accounts will proliferate as the product of choice for insurance company mandates. Insurer's bespoke investment strategy needs are likely to be assessed against a liability-driven benchmark and involve maximising returns while minimising capital charges. Such a mandate will, of course, be subject to enhanced data reporting requirements and the cost implications of the additional workload. Taken together, these factors mean that a separately-negotiated segregated mandate is likely to be the most attractive option for both insurance company and manager.

Managers should review the arrangements they have with data vendors (such as Bloomberg and Reuters) to ensure they provide sufficient information to fulfil the Solvency II data requirements. In addition, given managers' incoming quality assurance obligations, thought should be given to the reliability of the data sourced from third parties and the availability of legal recourse in the event of errors. This process should culminate in a thorough review of internal data management processes as these processes will be subject to significantly increased scrutiny, possibly leading to specialist teams focused purely on the provision and quality assessment of the data flowing through the manager.

Managers need to be confident that data given to insurers, even on an ad hoc basis, has been quality checked and that appropriate systems and processes are in place. This is particularly important since ad hoc data requests are most likely at the very time when such data is likely to be most unreliable or even unavailable (put differently, in times of market stress or crisis). The legal implications of the increased flow of data around managers and other service providers also need to be considered. In-house legal teams should ensure that the necessary documentation (such as non-disclosure agreements and service level agreements) is in place well in advance, as these can take time to implement. The quality and reliability of the systems in place to manage data will be of primary importance and managers should focus attention on building systems that can deliver the Solvency II requirements. Administrators should be closely involved in this process and should also be asked to review valuation methodologies for compatibility with Solvency II requirements.

There is much to do to produce a Solvency II-compliant offering for insurance clients, but the complexity also constitutes the opportunity. The universe of managers who can offer this service is likely to be small, meaning that the potential rewards are substantial for those prepared to make the necessary investment.

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