Solvency II –
A new competitive
parameter?

axxsys

Introduction

Investment managers are facing a new world of Solvency II. A legal requirement for insurance firms – yes, but observing the challenges that investors face, they will surely look carefully, for investment managers (IM) that deliver the most straight forward services in this concern.

Managers that fully understand the range of consequences the mere composition of portfolios will have, the risk it contains, and how it is managed, leading to the degree of transparency etc.

The aim of the Solvency II regime is to provide a significantly higher level of capital management. Meaning that insurance firms (IF) are forced to have increased focus on the balance sheet from a risk perspective. How can I achieve the best returns, while complying with the different rules and regulations'; for investment managers, whose aim it is to offer the insurers a high return to keep their business, they need to be aware of which new factors these clients are forced to look at.

Axxsys™ has stressed the most important factors asset managers should be aware of when entering the new world of Solvency II. In short:

– The IM needs to have an understanding of the models used by the insurer for calculating Solvency Capital Requirement, SCR. *At best the IM is able to simulate the impact on the clients SCR, and the impact of different risk scenarios.*

– The IF's have to document own risk and solvency assessment, ORSA. One of the requirements is that the IF is able to document that he is in full control of his asset manager. IF is responsible for the data quality of the received data. *At best IM's set up the framework for all services delivered in close cooperation with the client.*

– The IM needs to be aware of which information level he is required to provide for the insurer. *At best, data delivered contains all extended information, related to identification, transaction, position, diverse key ratios and characteristics, which are required for the clients Solvency II reporting. Both on fund and asset level. Transparent data is an absolute minimum.*

Solvency II Framework Directive		
Pillar I Qualitative Requirements	**Pillar II Supervisory Review**	**Pillar III Reporting**
– Assets and Liabilities – market consistent valuation – Investments – Solvency capital requirements (SCR) – European Standard Formula, or Internal Model – Minimum capital requirement (MCR)	– System of governance – Own risk and solvency assessment (ORSA) – Supervisory review process – Supervisory Intervention including capital add-ons	– Public Disclosure annual solvency & financial condition report (SFCR) – Information to be provided for supervisory purposes (RTS)

Overall the intention of Solvency II is to provide:

– Alignment of economic and regulatory capital including giving appropriate recognition to diversification benefits within companies and between subsidiaries

– Freedom for companies to choose their own risk profile and match it with an appropriate level capital

– An early warning system for deterioration in solvency by active capital management

– By better aligning risk and capital management, encouraging an improvement in the identification of risks and their mitigation.

For more background on Solvency II please see Axxsys White Paper

Solvency Capital Requirement, SCR

The IF can choose to build his own model or use a standard model. Depending on his internal needs and resources. Either way, the IM needs to understand the IF clients model and react to it. To a much higher extent risk management covers the whole balance sheet. How will one asset/fund affect the balance, the particular mix of asset and liabilities. How will the balance sheet react under different risk scenarios when adding this particular asset/fund to the portfolio. IF clients will highly appreciate or even require that the IM is able to understand and provide this information before trading.

As asset allocation will change character according to IF optimising under the regime of rules leading to you as an IM to be flexible and adjust your palette of products to match the new demand.

Own Risk and Solvency assessment, ORSA. Supervision of outsourced activities

The IF needs to have a clear risk strategy which again is under supervision of the Financial Services Authority, FSA. One of the things required is supervision of all outsourced activities, where the outsourcing to an IM has a big share. This means that IFs will have to clarify that he is in control of you as an IM and the data you deliver. The IF is responsible for both the quality and the delivery. To be able to do this requires a close cooperation between you and the IF, which is also the intension of the rule. The operational risks regarding outsourcing must be under constant surveillance implemented in a structured governance.

Public and internal disclosure. Data enrichment

A great variety of reports must be published under the Solvency II regime. Both the number and content needs to be approved by the FSA.

A great part of the reports require a rich extension of the static data on assets as well as funds, with information describing the instrument. Characteristics and certain static data, key ratios are also parameters in the calculation of e.g. market values included in the SCR.

Depending on the IF's level, resources and priorities, it could be a differentiator, if you as an IM, can provide all these extensions, making data ready to go for reporting and calculation purposes. You will need to have some of this information in-house in any case, to be able to do simulations and stress-testing on the SCR.

'It will most likely be a competitive force. Full transparency as previously mentioned is a must.'

As you, as an IM, are under supervision from your client, you need to clarify the way you handle data, ensure audit trails on flows as well as having regular security checks established to ensure quality. Stability in the deliverance is definitely of high importance, a big effort in having surveillance over the flow, catching up if any irregularities as well as optimising speed will pay off.

Everything needs of course to be well documented.

Conclusion

Solvency II is still under progress, and still new rules will be implemented. An IM being up to speed with the activities going on in EIOPA will most likely be granted with respect and trust from his client. Showing he is progressive and willing to do an effort.

Seeing change as a source to new competitive strategies, which again can lead to increased marketshares, will definitely be a force.

Even in the US, insurance companies are looking into the Solvency II regulation, in order not risking loosing market shares, and looking for possible competitive advantages, by keeping up to date with activities in EIOPA.

Axxsys Regulatory Practice

We help investment management businesses understand and meet the regulatory challenges they face. Axxsys' operational expertise and long track record of working with the buy-side community are supported by our strong regulatory network and long-standing relationships with trade repositories, system vendors, clearing houses and ARMs. As a result, our technical specialists are uniquely placed to see regulation from the point of view of the client business, providing tailor-made solutions that manage regulatory risk and create value within the operating model.

Contact Information

+44 (0)20 7526 4900
info@axxsysconsulting.com
www.axxsysconsulting.com

New Broad Street House,
35 New Broad Street,
London,
EC2M 1NH,
United Kingdom

+44 (0)20 7526 4900

First Canadian Place,
100 King Street West,
Suite 5700, Toronto,
ON M5X 1C7,
Canada

+1 416 915 4186

616 Corporate Way,
Suite 2-4684,
Valley Cottage,
NY 10989,
United States

+1 845 459 2626

Fax: +44 (0) 20 7526 4901

axxsysconsulting.com

info@axxsysconsulting.com