www.pwc.nl/nl/asset-management

Solvency II, the practical implications for asset managers and insurers

December 2014

pwc

Introduction

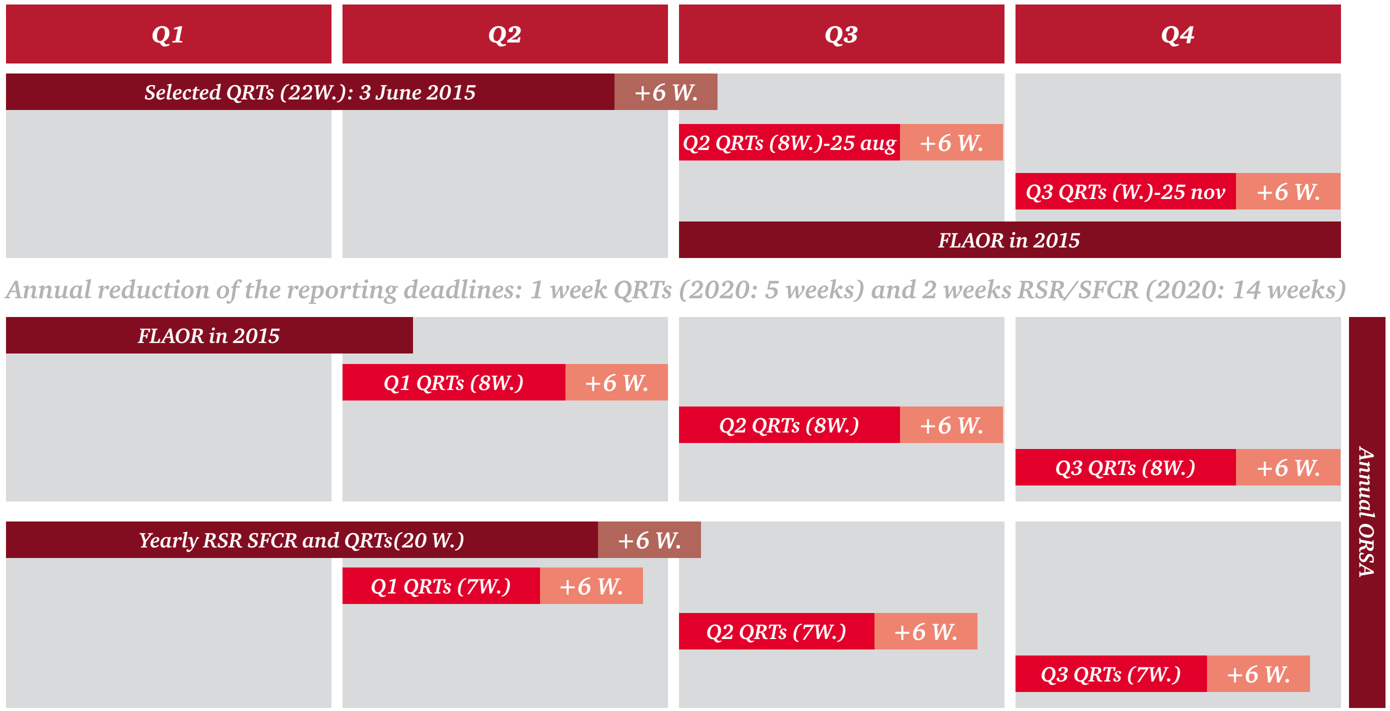
Solvency II is the most significant change for the European (re)insurance market in recent years. Solvency II will establish a revised set of capital requirements, risk management standards and disclosure requirements.

Unlike previous regulatory regimes, all the requirements are now closely linked with the asset side of the insurer's balance sheet. Therefore asset managers are now directly and indirectly involved in the insurers struggle to meet the defined regulatory requirements. For insurers it is therefore vital to involve their asset manager(s) in becoming compliant with Solvency II requirements. Asset managers servicing insurance clients will run into specific demands from insurers related to Solvency II and therefore need to ensure that their asset management (including reporting) services and their client management are up to the new standard.

Insurers need to comply with the Solvency II requirements as of January 1st 2016. However, even starting from January 1st 2015 a number of requirements already need to be fulfilled by insurers especially with regard to reporting requirements.

Main conclusion is that preparatory guidelines will be implemented in 2015 to prepare for the definite Solvency II implementation in 2016. Selected quantitative reporting templates (QRT's) have to be supplied to the regulator in 2015 and there will be an annual reduction of the reporting deadlines.

The timelines for Solvency II:



Solvency II – an insurers perspective

Looking at the asset side of the balance sheet and the actual managing of assets and the investment policy, the following elements are relevant in Solvency II to discuss with the asset manager:

Solvency II
Overview of the framework

Pillar 1	***Pillar 2***	***Pillar 3***
Quantitative requirements • Market consistent valuation of assets and liabilities • **Calculation of the solvency capital requirements (SCR) through internal model or standard formulas** • Minimum Capital Requirement (MCR) • **Demands on investments** • Tiering requirements forown funds	***Qualitative requirements*** • Supervisory review process - Intervention powers of the supervisor (incl. premium on capital) - Governance system - Internal controls - Risk management systems - Functional roles and responsibilities - **Own Risk and Solvency Assessment** - **Outsourcing asset management function** - emergency planning • New options of regulatory control	***Disclosure & reporting requirements*** • Extensive reporting obligations: - Report on solvency and capital resources - Regular reports to the regulatory bodies • **Details on individual items (especially multi-stage investments)** • Annual and quarterly reports

Impact on Asset Managers

• Enhanced ***requirements with regard to data***
• Increased ***information and reporting obligations***
} in term of scope, granularity, aggregation & frequency

➔ Higher level of control of the investment activities of asset managers by the insurance companies

Pillar I: insurers have to calculate the SCR (solvency capital requirements) based on their asset mix and liabilities. This has a direct impact on the models used, choice of investments and balance sheet management. In order to perform these calculations, granular asset data is required that is (often) managed by asset managers. Especially in case regulators adopt the same approach as the PRA in the UK that insurers need to provide a reasonable assurance opinion, accurate, complete and auditable data is required.

Insurers can use two models to calculate the SCR: they can either use a standard model or develop an internal model. We see in the market that large insurers have started to build internal models, while smaller start with the standard model. Asset managers should start discussions with their clients to see what the specific requirements are. Given the effort, resources and costs involved usually the larger insurers need to develop an internal model.

The choice of the model can impact the outcomes of the SCR for specific investment instruments significantly which also impacts the demands on the investments. The insurer therefore needs to discuss with his asset manager to what extent he requires his asset manager to provide SCR calculations on specific assets and based on what models and how specific investment decisions impact his balance sheet. After the discussion the insurer needs to determine what models will be used as part of balance sheet management and risk management. Key element in this observation is that insurers are in a squeeze: they would like to obtain a higher return, while on the other hand they have to keep higher capital and solvency requirements. Insurers have to optimize their balance sheet management and their asset allocation.

Box 1: *"SII redefines the amount of available capital we have in our balance sheet ("Own Funds") including the impact on balance sheet management and it redefines the calculation of required capital to be solvent ("SCR")." Quote by a large insurance company in the Netherlands.*

Pillar II: Solvency II also has strict requirements with regard to managing outsourced services. Although asset management is (often) outsourced to either external or internal asset managers, the insurer remains fully responsible for managing the outsourced services. Ensuring that the outsourcing framework is up to par and being able to demonstrate that you remain 'in control' of your outsourced services is crucial. Although some guidance has been provided already with regard to outsourcing, more advanced guidelines are still being developed at this moment. We foresee however that these guidelines will focus on the need to explicitly show that insurers have set up adequate governance to set up and monitor the outsourced asset management services. The outsourcing of asset management should also be included in the insurer's Own Risk and Solvency Assessment (ORSA) process and risk management processes as this will have impact on the risk profile of the insurer.

Box 2: *"SII requires us to perform a comprehensive risk assessment, analyzing the impacts of various long-term scenarios on our solvency ("ORSA"). SII requires management to understand our company's risks and include them in decision making (part of "Use Test")."*

Pillar III: in order to supply the quantitative reporting templates insurers need detailed information from asset managers with regard to their own investment portfolio. Solvency II will require approximately 70 QRTs covering areas as Balance Sheet, Own Funds, Assets, Solvency Capital Requirement and Minimum Capital Requirement (SCR/MCR), Technical Provisions, Variance Analysis, Reinsurance, Country & Cover and Group (G, IGT, RC). Examples include line-by-line look-through data classified per asset type, currency and region. Insurers therefore need to ensure that their information requirements are clearly defined towards asset managers and are included in Service Level Agreements and other outsourcing agreements.

Box 3: *"SII requires extensive and detailed reporting of Financial and Risk information and SII requires us to evidence that we control all of the above."*

How can asset managers react to Solvency II requirements

Managing assets on behalf of insurers will change due to the implementation of Solvency II. Insurers will require additional services from asset managers to ensure that they can comply with the new regulation.

This is also an opportunity for asset managers and custodians to strengthen their relationship with their clients by helping them with Solvency II adjusted services and products to overcome the regulatory burden and to gain new market share. This includes understanding risk as a competitive advantage, understanding balance sheet management, effective derivative overlays, data management & data quality and Solvency II optimized asset mix. Asset managers should therefore focus on a number of aspects to be able to service insurers in the near future:

1. Asset managers are required to have a detailed understanding and modeling of risk in relation to the specific insurer and the model(s) used by the insurer and should advise the insurer with regard to the strategy it pursues (balance sheet management):

- Asset managers have to understand the underlying risks that insurers are facing (and thus need to be able to model them)
- Asset managers need to be able to provide look-through data on investments. Insufficient transparency can trigger punitive capital charges (e.g. for funds)
- Asset managers need to have high quality data and ensure that data availability is high as well to ensure compliance for insurers.

These requirements will increase in importance in case the regulator will adopt the same approach as the PRA in the UK and will require assurance from the insurers with regard to their balance sheet and own funds review. In the UK insurers need to obtain a reasonable assurance opinion over their balance sheet, technical provisions (excluding risk margin) and own funds from an external audit firm.

2. Asset managers also need to be aware how investment decisions will impact their product offering. Insurers will base their asset allocation on the implications of investments on their solvency requirements. This triggers the following economic considerations:

- Capital treatment per asset for insurance firms can impact financial markets
- Illiquid fixed income is generally attractive (mortgages, infra loans, etc.)
- Asset-attractiveness will be more dependent on the liability profile (matching adjustment)
- Less freedom for the asset manager due to stronger match of assets with liabilities.

A number of Solvency II implementation requirements still need to be defined on a more detailed level. Asset managers therefore are still uncertain how to adapt their service offerings to these changes. Future developments can have effect on:

- Servicing for mandatory requirements for insurer: insurer can engage in activity where they will provide enough information to meet the minimum requirements that are expected by legislation or that asset managers will undertake additional effort in order to optimize the entire process
- Asset managers can develop new service offerings to support insurer in becoming compliant for solvency II legislation
- Need for practical advice that can actually be implemented (derivative overlays?)
- Investment solutions that fit in the balance sheet strategy (for assets and liabilities).

However, prior to focusing on additional services, asset managers should get the basics right first:

- Asset managers need to deliver the asset data as required and in a timely fashion
- Asset managers need to be transparent where possible, on both process and data.

Implications for asset servicing providers

Note that besides asset managers, also asset servicing providers will play a role in providing information to insurers.

Asset servicing providers have access to all the data required for the insurer and are therefore qualified to provide insight in the data required. Based on our round table discussion (see page 7), the service provider's perspective with regard to the information requirements of the insurer is displayed below. The main issue is the extensive asset data requirements:

Identification

- Portfolio
- Fund Number
- ID Code
- ID Code Type
- Security Title
- Issuer Name
- Issuer Code
- Issuer Group
- Issuer Group Code
- Counterparty Name
- Counterparty Code
- Counterparty Group
- Counterparty Group Code
- Contract Name
- Name of Debtor Pledging the Collateral
- Group of Debtor Pledging the Collateral

Categorisation

- CIC
- Issuer Sector
- Use of Derivative
- Type of Structured Product
- Collateral Type
- Asset Category
- Type of Asset
- Held in Unit Linked Fund

Transactional

- Premium Paid/Received to Date
- Trade Date
- Profit and Loss to Date
- Net Gains and Losses
- Acquisition Cost
- Near Leg Amount
- Far Leg Amount
- Swap outflow amount
- Swap inflow amount

Positional

- Quantity
- Unit SII Price
- Acquisition Cost
- Total SII Amount/Value
- Accrued Interest
- Collateral
- Notional Amount
- Long or Short Position
- Number of Contracts
- Swap outflow amount
- Swap inflow amount
- Start Date
- Dividends Accrual
- Interest Accrual
- Rent Accrual

Characteristics

- Valuation Method SII
- Issuer Country
- Country of Custody
- Currency
- Participation
- External Rating
- Rating Agency
- Duration
- Capital Protection
- Underlying Security/ Index/Portfolio
- Callable or Putable
- Synthetic Structured Product
- Prepayment Structured Product
- Fixed Annual Return
- Variable Annual Return
- Loss Given Default
- Attachment Point
- Detachment Point
- Asset Underlying the Derivative
- Delta
- Contract Dimension
- Trigger Value
- Unwind Trigger of Contract
- Maximum Loss under Unwinding
- Swap Delivered Currency
- Swap Received Currency
- Maturity Date
- Underlying Asset Category
- Geographical Zone of Issue
- Currency – Local or Foreign
- Type of Repo/Securities Lending
- Buyer or Seller / Lender or Borrower

Source: presentation BNY Mellon

Lessons learned from round table discussion

PwC conducted with the leading asset managers and custodians a round table discussion on solvency II.

Based on the round table discussion we learned that:

- A large part of the insurers started to discuss Solvency II requirements with their asset managers. These discussions need to gain momentum to ensure that insurers will make their Solvency II implementation dead-line as a lot of decisions need to be made and implemented on managing assets on behalf of insurers
- Solvency II will impact asset allocation and investment decisions for insurers. The use of either the standard model or an internal model will have impact on solvency implications of instruments and will therefore impact the investment decisions and financial markets overall
- Outsourcing agreements, contracts and service level agreements need to be updated to ensure the insurer has adequate tools to monitor their service providers (asset managers) and demonstrate that they remain 'in control' of their asset management activities
- A number of questions remain with regard to both quantitative and qualitative data requirements (for example on classification on specific hybrid instruments). However, data on instrument level is mandatory, including look-through information for fund structures
- Asset managers need to make sure that they can live up to the expectations that will be needed to manage assets for insurers in the new setting. Portfolio managers for example need to make sure that they can include impact of investments on capital requirements and back-offices need to ensure they can provide the data as required. In their service offerings, asset managers should asses their added value for their (insurance) clients in order to remain competitive in the market
- Keep in mind that Solvency II is only part of the regulatory landscape. It should be managed in relation to other regulatory changes, for example AIFMD, EMIR and MiFid II.

'Solvency II will impact asset allocation and investment decisions for insurers.'

What steps need to be taken?

Both insurers as well as asset managers need to move forward to ensure that insurers comply with Solvency II requirements in time.

Insurer

1. Insurers should revamp the discussion with their asset manager(s) on how to comply with Solvency II for their investments. They need to discuss what services the insurer will need from their asset managers. Insurers should furthermore discuss impact of Solvency II on investments, risk implications (ORSA and SCR calculations), outsourcing, strategic asset allocation, balance sheet management and data requirements
2. Governance of the outsourcing situation should be updated and roles and responsibilities need to be redefined. An Operational Due Diligence could be part of this process. Outsourcing agreements and SLAs need to be amended to reflect the new governance
3. Data requirements need to be defined and discussed with the asset managers to assess whether the requirements can be satisfied.

Asset manager

1. Asset managers should assess what kind of service they will provide to their insurance clients and should challenge requests from their insurance clients on services that they need to provide
2. Asset managers should ensure that their portfolio managers will be able to manage investments based on capital requirements of their insurance clients and optimize investments differently than before
3. Asset managers should ensure they can provide the required data with sufficient quality in a timely manner. Asset managers need to ensure that their IT systems and operations can manage the requirements to meet client expectations.

Contacts

Patrick Heisen
Director
T +31 (0)88 792 5970
M +31 (0)6 30 48 37 84
patrick.heisen@nl.pwc.com

Arthur Kilian
Director
T +31 (0)88 792 3035
M +31 (0)6 34 92 14 62
arthur.kilian@nl.pwc.com

Casper Lötgerink
Manager
T +31 (0)88 792 3526
M +31 (0)6 10 92 24 56
casper.lotgerink@nl.pwc.com

Martin Weirich
Manager
T +31 (0)88 792 5215
M +31 (0)6 22 87 67 46
martin.weirich@nl.pwc.com