Technical Viewpoint

Solvency II: optimizing the investment portfolio – practical considerations for asset managers

European Asset Management Viewpoint Series
Solvency II: optimizing the investment portfolio – practical considerations for asset managers

This paper explores what asset managers can do to seize investment process and product development opportunities ahead of the Solvency II regulatory changes. It sets out some practical considerations for portfolio construction and optimization, taking into account the proposed capital charges. We conclude with a call for asset managers to embrace the opportunities presented by Solvency II.

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Solvency II presents an opportunity for asset managers managing insurance assets

Solvency II will fundamentally change the European insurance industry's capital adequacy regime. When implemented during 2014, it will establish a revised set of market-consistent EU-wide capital requirements and risk management standards.

Solvency II will have a number of direct and indirect impacts on the asset management industry, one of which is that it will lead insurers to review their asset allocations. We believe this presents an opportunity for asset managers.

In our previous Viewpoint: Solvency II: the opportunity for asset managers, we discussed how the new regime will affect insurers’ investment decisions and, by extension, asset managers’ business models. In this paper we explore what asset managers can do to optimize investment returns and retain and capture insurance business in anticipation of Solvency II.

“Solvency II will fundamentally change the European insurance industry’s capital adequacy regime.”
Maximizing risk-adjusted investment returns will be vital under Solvency II

Under Solvency II an insurer’s capital requirements are determined using the Solvency Capital Requirement (SCR) formula. This risk-based approach takes into account the risks inherent in the assets and liabilities on the balance sheet. As a result, investment decision-making will need to take account of return after risk and the capital cost of that risk.

Insurers have the option to calculate their capital position using a standard model published by the European Commission (EC), an internal model or a combination of the two. An insurer’s choice will depend on how closely the standard calculation reflects the risks within its portfolio and, most importantly, its capacity to invest in a proprietary model. As such, it is generally the small and mid-tier insurers that are adopting the standard model. Among the larger players choosing to adopt an internal model, applications for regulatory approval are already underway. This process is expected to complete towards the end of 2012.

We believe there is an opportunity for asset managers to help insurance clients manage their balance sheets by developing their own versions of the SCR model, ideally based on the insurer’s chosen approach. Assets are stressed in the market and counterparty risk components of the SCR calculation, with seven asset risks covered in total. The liability side of the calculation should also be included, or typical liability profiles could be used. Should the liability information not be available, a solely asset-based assessment will still create value given that around 60% of Solvency II pre-diversification capital requirements are expected to stem from market risk¹.

Asset managers have already started to use this portfolio optimization approach to assess the capital efficiency of their portfolios, and understand how insurers’ internal models may treat the funds they manage. We expect this trend to continue. By extension, this approach could be incorporated into an asset manager’s portfolio optimization workflow. Allocation and rebalancing decisions could then take risk-adjusted returns on capital into account.

¹Morgan Stanley, Oliver Wyman research, 2010
Diagram 1. The Solvency Capital Requirement (SCR)

Source: European Commission QIS5 technical specifications
We expect Solvency II’s focus on risk-adjusted returns to increase the use of risk-budgeting within the portfolio management process. This is most likely to be used by insurers with relatively comfortable capital positions, able to take higher risks as long as expected returns are within their requirements.

In simple terms, risk-budgeting is the process of decomposing the aggregate risk of a portfolio into quantitative components and allocating limits or “budgets” to each risk. Portfolio rebalancing then takes place in line with assigned risk budgets, which are normally defined in the fund mandate.

A prerequisite for the risk-budgeting approach is the requirement for ex-ante risk calculations to be embedded into the investment process allowing portfolio managers to operate within risk constraints and to see the impact of capital charges on risk-adjusted returns.

“... risk budgeting is the process of decomposing the aggregate risk of a portfolio into quantitative components and allocating limits or ‘budgets’ to each risk.”
Data capture and classification are vital considerations for an asset manager building its own version of an SCR model. Each portfolio will need to be sub-divided into various categories to reflect the risks attributable to every type of asset. We expect some firms to struggle with this process, since the requirements of the model will not necessarily match current asset classifications. Market data providers are starting to consider solutions to assist with this, but exceptions will still need to be accommodated.

In some cases, investment will be needed to ensure that asset data has the attributes required for the calculations. Data validation activities will also need to be put in place to assure data quality. The good news is that the data provision activities for insurance clients’ existing Solvency II reporting requirements should give asset managers a solid base to build on.

Depending on the size and nature of an asset manager’s insurance client base, investment may also be required to fully integrate the Solvency II portfolio optimization model into investment processes, IT systems and other support functions. Asset managers regularly offering this service to a large number of insurance funds will be keen for a more integrated and repeatable solution.

Asset managers adopting a Solvency II portfolio optimization approach will be able to provide enhanced statements to their insurance clients, incorporating further risk analysis as well as the output for each market and counterparty risk component. An assessment of each component could help insurers to understand the drivers of their overall portfolio composition. These enhancements will also allow insurers to reconcile their own SCR model outputs with those produced by the asset manager. At a time when insurers are developing and implementing new models, this additional data control could provide added comfort around regulatory reporting numbers.
Solvency II will place a greater emphasis on asset-liability matching (ALM), with duration mismatches attracting a higher capital charge under the interest rate component of the SCR calculation. Asset managers will therefore need to be able to demonstrate a quick and dynamic ALM process with robust monitoring controls.

The new regime will place a lower capital charge on derivatives and short-dated bonds. We therefore expect to see increased use of derivative overlays to achieve duration matching, in conjunction with a shortened physical investment portfolio. From a practical perspective, derivative overlays will need to be managed by a specialist team accustomed to these strategies and who understand the risks involved in using these instruments.

Concentrated investments will incur a high capital charge under Solvency II, so asset managers will seek to maximize diversification via a broader and more innovative portfolio management approach. As a result, we expect asset managers to make greater use of swaps and other derivatives to construct total return portfolios. We also anticipate increased demand for structured interest rate products - to hedge against long duration liabilities - and for strategies that hedge against changes in the value of with-profits investment guarantees.

As a result, many asset managers will need to enhance their ability to analyze, trade, value and monitor complex products and derivatives. This represents a particular challenge for small and mid-tier firms, since it may require expensive changes to systems, processes and controls. It will also place increased pressure on the recruitment and retention of skilled employees that understand these instruments. This is not just a consideration for the investment area, but for the entire organization and any outsourced service providers.

Overall, Solvency II will encourage asset managers to develop a new degree of sophistication. Ultimately, some firms may reach the point where they can compete with the investment banks in areas such as hedging or duration strategies. Certainly, some global asset managers are already moving in this direction.
Some investment banks, recognizing the additional pressure Solvency II will put on the delivery of portfolio returns, have already started to develop capital-efficient structured products. These products effectively replicate the performance of an asset offering a higher risk and return profile, but are structured like an instrument attracting a lower capital charge – such as short-term debt. The Solvency II rules regarding treatment of assets are continuing to evolve, so it is not yet clear how these instruments will be treated under the new regime. As such, many investment banks and insurance companies are adopting a “wait-and-see” approach to these types of products.

Structured products may give a desirable boost to portfolio returns but their composition and investment risks require rigorous appraisal, as the capital charge needs to reflect the true nature of the product. Complex products may be very effective on a small-scale basis, but the possibility of regulatory scrutiny should discourage any wholesale risk-taking of this kind.

“Structured products may give a desirable boost to portfolio returns but their composition and investment risks require rigorous appraisal, as the capital charge needs to reflect the true nature of the product.”
A proactive and creative approach by asset managers can help retain existing clients ...

Solvency II will prompt insurers to place additional scrutiny on the mandates being run by asset managers. In our view, asset managers that adopt a proactive approach to Solvency II requirements will enjoy the strongest client retention. This means engaging with insurers on risk and return optimization, including an understanding of their liability profile, rather than focusing on pure return generation or index tracking.

Asset managers will need to be able to demonstrate that they understand an insurer’s requirements, that they can meet their needs in terms of data and that the funds they offer have the correct structure to optimize capital requirements under Solvency II. Firms that can use ongoing portfolio optimization to ensure they are achieving the most capital efficient portfolio, as well as maximising risk and return, will also help their insurance clients with day to day balance sheet management.

Finally, the value of education should not be underestimated. Asset managers are well placed to offer advice and input to the insurer on allocation changes and asset mixes. Asset managers should see this as an opportunity to get closer to their strategic clients and to further develop key relationships.
We expect new insurance clients to have a keen interest in how prospective asset managers will run their portfolios under Solvency II. In our view, asset managers that can demonstrate an understanding of the constraints the new regime places on insurers - and the tools to respond accordingly - will gain a competitive edge over their peers.

Solvency II portfolio optimization tools incorporating an asset manager’s own version of the SCR model can be embedded within the client take-on process. This practical demonstration will allow insurers to see first-hand that an asset manager has considered Solvency II portfolio constraints within its investment processes and supporting technology.

Leveraging Solvency II portfolio optimization models can also help asset managers gain a competitive advantage by providing the basis for developing new “Solvency II friendly” products. These will be of particular interest to small and mid-tier insurers with limited in-house asset allocation capabilities. Such firms may be looking to exit funds with unacceptably high capital charges. A low-cost, one-size-fits-all approach could be a viable business model for asset managers and hedge funds looking to play in this space.
We expect the scope of services offered to insurance clients to broaden under the influence of Solvency II, reflecting the additional complexity the regime will create in asset allocation and risk modelling. There is a particular opportunity for firms to extend their offering to small and mid-tier insurers, providing additional help and advice around allocation strategies and how investment mandates may need to be changed.

In time, some asset managers could even develop a service to assist insurers by refining their internal models to better reflect inherent risks and reduce their overall capital charge. Given asset managers’ expertise in analyzing the risks and composition of asset portfolios, they are well placed to help insurers prepare evidence to submit for regulatory approval. This could be offered as a paid service to insurers, reflecting the intensive use of data and resources, although a view would be needed as to whether the asset manager could justify this as part of their business model.

“Given asset managers’ expertise in analyzing the risks and composition of asset portfolios, they are well placed to help insurers prepare evidence to submit for regulatory approval.”
Conclusion: asset managers should seize the opportunities presented by Solvency II

To date, asset managers have been adopting a range of approaches to Solvency II. At one end of the spectrum some asset managers are opting to do no more than provide validated and formatted asset data to their insurance clients to allow them to fulfil their regulatory obligations.

On the other hand, some global asset managers are viewing Solvency II as an opportunity to demonstrate a more proactive and collaborative approach to their insurance clients. Hedge funds are taking the opportunity to understand more about how each of their strategies will be viewed under Solvency II, and some managers see an opportunity to start to acquire insurance business by offering Solvency II friendly products.

To continue to compete, some asset managers will require a greater level of sophistication to help insurers deliver returns in more innovative ways. This may require improvements to investment processes and supporting tools, as well as ensuring that personnel are appropriately skilled. We expect small and mid-tier managers that currently lack the processes and expertise to handle large-scale complex strategies to face the greatest challenges. Some may decide to exit the market if they cannot offer the desired complexity.

Solvency II provides a number of opportunities, and we urge asset managers to explore these now if they want to remain competitive in the insurance marketplace in the future.
Solvency II: optimizing the investment portfolio – practical considerations for asset managers
Other viewpoints within our Solvency II series include:

- Solvency II: The opportunity for asset managers
- The impact of Solvency II on asset managers

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