HOW CAN INSURERS AND REINSURERS MAKE THE BEST OF SOLVENCY II?

Since January 1, 2016, insurance and reinsurance companies in the European Union have had to comply with the requirements of Solvency II. The stress tests of this new directive imposes on their balance sheet (on both the assets and liabilities) to determine the Solvency Capital Requirements (SCR) – may clearly have a major impact on their investment strategies. Cyrus Amaria and David Niddam explain how Lyxor can help and assist insurers and reinsurers in making smart, cost-effective and absolute return investments in this new and somewhat complex regulatory environment.

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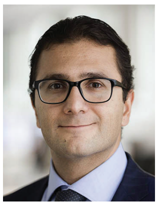

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>> SPEED READ

- >> Under Solvency II, insurers and reinsurers have to undergo stress tests on both the assets and liabilities, to determine the solvency capital required.
- >> Detailed prudential reporting requirements make transparency a critical issue for insurers.
- >> Lyxor has devised investment solutions that are able to significantly reduce insurers' SCR specifically in regards to direct investments in alternatives or equities.
- >> Lyxor's dedicated solutions offer a high level of transparency which is key for insurers and their ability to calculate both the Minimum Capital Requirement (MCR) and Solvency Capital Requirements (SCR).
- >> Lyxor's reporting solutions help enhance transparency and enable a greater understanding of the investment drivers of a portfolio.

WHAT IS TRULY AT STAKE FOR INVESTORS?

DN: To comply with Solvency II, insurers have to have their balance sheets assessed and tested, so they can show their ability to withstand systemic shocks, and to provide the corresponding oversight body – For example in the UK, the PRA - Prudential Regulation Authority with fully detailed prudential statements, that will determine the solvency capital requirements. So clearly, they need very thorough knowledge of the positions of each of their investments, which means transparency becomes a critical issue for investors. As a consequence, the ability to deliver the required level of transparency now is a discriminating factor for asset managers.

As can be expected from a Directive aimed at protecting insurance policy holders, Solvency II errs on the side of caution. In other words, the "riskier" the investment, the higher the SCR. Typically, it will go up to 49% for an investment in the equity market. So even though their liabilities are fully hedged, insurers willing to invest GBP 100M will be required to hold GBP 49M in capital. This obviously considerably lowers the potential performance of their investment and calls for newer strategies of risk based asset allocation. For investors, getting the right advice on how to best embrace risks and make smarter investment decisions is now essential.

CA: As David just explained, certain asset classes and investment strategies have, on the surface, become significantly unattractive due to the requirements of Solvency II. Equity and alternative investments are two such examples, with a high SCR attached to them.

So the natural, logical trend to follow for insurers would be to divest their allocation from these investments and to redirect them towards lower SCR-consuming classes, such as bonds, but with much lower potential return. Simply put, investors seem to find themselves stuck with a simple, yet unattractive choice: either they opt for very high potential returns, but with heavy associated risks, or they turn to something significantly less expensive that will likely not meet their expectations in terms of return on capital.

DEDICATED SOLUTIONS TO REDUCE CAPITAL COSTS

CA: What investors need to know is that there are simple and transparent management techniques which significantly reduce capital costs, and that they will be able to keep investing in theoretically SCR-consuming asset classes without having to hold too much capital. At Lyxor, we do advise our insurance clients not to shut the door on equity or alternatives, but to actually reconsider them and to let us see how we can cut the associated capital costs. As a matter of fact, we have proven our ability to reduce the cost of capital from 49 to 20%. In a very tangible manner, it means that the amount of capital consumed for a GBP 100M investment in equity or alternatives is no longer GBP 49M but GBP 20M. Which is what the EU regulation would normally demand for a GBP 100M investment in high yield bonds.

DN: Let me add something here: this might be stating the obvious, but our solutions are fully compliant with Solvency II. What we are explaining is that lowering capital costs, in total transparency, is something EU regulators do accept. There is no circumventing the Directive in any way. There are solutions to limit the SCR – the risk of capital loss – to 20% and thus the SCR, for both equity and alternatives. Through close cooperation with insurers, actuaries and the authorities well in advance of Solvency II's effective implementation, we have been able to build and provide practical solutions in terms of reporting requirements, transparency and investment solutions.
In particular, Lyxor has developed investment solutions enabling insurers to reduce the capital cost (or SCR) associated with equity investments and certain investment funds:

>> For equities, as a liquid OTC or regulated market, protection is available, Lyxor offers a combination of equity investments with protection (through options) enabling a reduction in the SCR cost (typically, from 39% to 17%) and in the risk per unit of capital exposed to equities. In addition, this approach is based on the insurers' equity portfolio and the specific characteristics of each insurer (cost of capital, equity market performance expectations, etc.) as they currently stand, without modifying any strategic or tactical allocations. In practice, Lyxor determines an optimal combination of derivatives instruments (protection level, underlying, maturity) aiming at delivering the best expected return per unit of capital at risk. Further, this solution also allows us to rationalize the recourse to protection even when market expectations are bullish. Indeed, it puts in perspective the equities expected returns versus the capital costs of gaining the exposure. Lyxor is one of the first to offer such a solution, and the experience and feedback has been positive from insurance clients.

>> For absolute return or long only investment funds, Lyxor has developed a portfolio insurance technique that enables the SCR to be calculated, in accordance with regulatory constraints, at a more appropriate level (in terms of Value at Risk) which, typically, for these asset classes is 20% instead of 49%.

CA: Alternative investments can play a clear role in a portfolio context. Liquid hedged investment strategies as a whole can be extremely complimentary to various asset classes and certainly no riskier than traditional classes. For those who already allocate to these strategies we can work with them on a non-intrusive approach. For others, the ability to team up with Lyxor comes with the benefit of our experience and expertise in selecting and allocating to alternative investments. This is what we do. We have a history of devising and implementing solutions that will offer both high-targeted returns and effective capital protection.
So, in a nutshell, our message to insurers and reinsurers is to keep looking into equity or alternative strategies, which provide the great benefit of diversification and low correlation to classic assets, and we can help manage this in a more SCR-efficient manner.

BETTER, FASTER AND MORE ACCURATE REPORTING

DN: In addition to these dedicated investments strategies and tools, we have also identified solutions which are directly linked to reporting. Solvency II requires quarterly reporting on all prudential documents, using either a standard reporting model, defined by EU regulators and built in close cooperation with the industry, or an internal model, that can be company-specific, but has to be approved by regulators.

In the EU-devised standard model, both alternative and equity management require heavy SCR provisions, and all positions –long and short– are aggregated. In other words, what is taken into account to determine capital solvency requirement is the "gross" situation of an investor, as opposed to his "net" position. So there again, our strong long-standing commitment to transparency and our deep understanding of our clients' needs make us uniquely able to assist them in analyzing the impact of new and more diversified investments, which can result in SCR reduction.

CA: Our transparent solution aims at making insurers realize that there are opportunities for investments in better performing asset classes, without it being too costly, even with the standard reporting model. Of course, it is even more true for insurers who are using an internal model. As a matter of fact, once their liabilities are fully known and hedged, all insurers have to go through the same investment process: What is the potential of the asset class? How costly is it and what can I expect in terms of performance and downside deviation? How do I optimize my asset allocation and what will it entail in terms of transparency and reporting? Our job is to help our clients find the best answer to each of these questions. This is precisely why we offer our services in either an advisory or fully discretionary capacity, we take the requirements from an insurers' investment committee and devise a comprehensive investment strategy for them. The portfolio transparency and the overall reporting tools have a high added-value.

DN: Just to expand on what Cyrus said, we obviously have the means and resources to provide quarterly reporting, as required by Solvency II, but we also go the extra-mile for our clients. As a matter of fact, we provide full and detailed monthly reporting on most of our funds. Also, we know liquidity is absolutely crucial. So we want to give investors the ability to have quick and frequent access to their money and to make informed decisions about how to invest it. This is part of our commitment to reduce costs, increase liquidity and enhance transparency.

SOLUTIONS THAT HAVE ALREADY BEEN SUCCESSFULLY DEPLOYED

CA: Even though Solvency II has only been in effect for a little over two months, we have been fully prepared for much longer than that. We have responded quickly to the demands of insurers and reinsurers, in several countries and have already secured significant deals with insurance companies in the UK, and countries of the British Overseas Territories. Not to mention the large number of potential clients who have approached us for our reporting solutions.

By reducing the SCR from 49% to 20%, the benefits to an insurer are meaningful. With the additional transparency and in full compliance with the requirements of Solvency II this is set to be a solution in high demand. The success of the solution will be the longer term health of the insurer's investments and their ability to produce a higher return on capital.

>> SOLVENCY II

The Solvency II Directive is an EU Directive that codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies and reinsurance funds must hold to reduce the risk of insolvency. Following an EU Parliament vote on March11, 2014, Solvency II came into effect on 1 January 2016

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