

The big issue

New regulation, especially Solvency II, is causing insurers to worry about what it means for their asset management strategies.



Insurers are continuing to struggle with the impact of regulation – and especially Solvency II – on their asset management strategies.

“I saw a survey recently that hit my desk from the CSFI [Centre for the Study of Financial Innovation]. They do a survey every couple of years and their most recent survey had, across all markets, regulation as the number one topic of interest among insurers,” says Woody Bradford, CEO of Conning.

“That’s very consistent with our experience and the conversations we’re having.”

Bradford, along with many of the asset managers who spoke to Reactions, says that the topic of regulatory changes and their impact on investment strategies is driving conversations with insurers, though he notes, “it’s another thing all together to be able to help clients think through what it means for their business and what it means for their investment strategy.”

Dirk Popielas, head of JP Morgan Asset Management’s European insurance solutions group, agrees, and describes regulation as “the number one issue” for insurers keen to shore up their asset management, even above maximising yields.

“If you analyse the list of priority issues, our experience that we see from our client meetings is that the number one issue is not investment performance like it was a year ago or maybe two years ago,” he says.

“That’s still a priority issue, but the number one issue that all of the board members, including the chief investment officers and CFOs, are concerned about is regulation and capital.”

A paradigm shift

This prominence is driven by continuing uncertainty over the weight of capital allocations that will be demanded by the European Union for particular assets, with the rules as they stand giving no capital weighting to sovereign debt across the board – something which has proven a controversial issue within the industry.

“It’s zero, but there’s no distinction between different types of sovereign debt. So Greek debt has the same treatment as German debt, which is completely irrational,” says Bradford.

Indeed, some asset managers suggest that the incoming regulatory regime will force insurers to act against their own interests in investments, with capital weighting strongly against certain asset classes.

“Solvency II is punitive towards things other than core investor created fixed income and sovereigns in particular,” says Randy Brown, global head of Deutsche Insurance Asset Management.

“[Insurers] have pressure because they have, on one hand, an economic need to diversify their asset base, but on the other hand there’s a regulatory push to limit their doing so,” he says. “And that’s a real problem that they face.”

Philip Michaelsen, JP Morgan Asset Management’s head of strategic insurance sales for the EMEA region, says that the firm recently did a case study based on the life sector that confirms these issues.

JP Morgan took an average asset allocation and built a generic balance sheet based on publically available data.

“The biggest takeaway for me certainly was that when we took the average asset allocation and ran it through an optimiser...what we ended up with was a portfolio that was more efficient in risk return terms. It had slightly lower return for substantially lower risk, so the optimiser did its job, but that same portfolio consumed almost 50% more capital,” says Michaelsen.

“It’s one example and we can’t say that it would be applicable to every single insurance company but what it does show is that there is this paradigm shift where traditional risk return frameworks are probably insufficient at this stage for the insurance industry trying to take into consideration Solvency II.”

“So this idea of capital-adjusted risk return becomes really, really important in the asset allocation decisions.”

Indeed, Popielas suggests that this is further complicated by the fact that sovereign bonds currently have low yields, even in an environment that broadly represents challenges in this area. Popielas argues that for some firms the result is a trade off between yield that will not provide particular benefits to the insurer and the lack of capital weighting allocated by the EU.

“The yield you can earn on French and German long-dated government paper is sometimes even below the hurdle rate – the



“[Insurers] have pressure because they have, on one hand, an economic need to diversify

their asset base, but on the other hand there’s a regulatory push to limit their doing so.”

Randy Brown, global head of Deutsche Insurance Asset Management

guarantee rate they have promised to their policy holder,” he says. “So it’s not meeting that interest and that’s why it’s like a trade the insurers are going into.”

Sovereign debt issues in Europe likely continue to loom large over any discussion of asset management as a result, with Brown at Deutsche Insurance Asset Management describing the EU as “dysfunctional at this point”.

“If you look at for instance a European portfolio, roughly 38% of the holdings would be in government and government related, on a typical portfolio... that’s a big number, it’s pretty concentrated,” says Brown. “If you added financials on top of that, you’ve got between treasuries, government related and finance, 70% of the securities are in those three sectors, which are all highly related.”

“So the outcome of the European sovereign debt crisis is going to have a big impact on the balance sheets of insurance companies overall,” says Brown.

Back at Conning, Bradford argues that this has led to a shift away from sovereign debts in the global market, but he says that the picture in Europe has been complicated by Solvency II because of concerns over capital charges, and fundamentally, what the final rules are likely to be.

“It really depends on what market you are in and what you’re talking about,” he says.

“In the US you’re seeing people shift away from the sovereign debt. You’re seeing more exposure to corporates, and you’re seeing people looking at expanding their equity positions, looking at expanding their non-domestic positions and then putting small allocations to alternatives and other specialised assets.”

Even for those insurers who accept the capital charges from the European Union that will come from alternative investments, there remain hazards caused by the lack of diversity on offer, says Brown.

“Most of them will tell you they don’t have big holdings in Greece or Portugal or Spain or Ireland and that type of thing, which is true,” he says. “But what it means is that by owning less of those sectors they need to own more of other sectors. So the implication there is more concentrated risk.”

Indeed, these problems are set to multiply with equivalence programmes in their nascence globally.

Not just a European issue

Matt Malloy, JP Morgan Asset Management’s North American head of insurance, notes that there is an expectation that there will be a global regulatory convergence around a risk based capital framework “that may look and feel a lot like Solvency II”.

“In the US, the risk-based capital system that is currently in place in some ways has had a form of what Solvency II represents for a very long time, so I don’t think it’s without some foundation in the same types of principles that Solvency II represents,” he says.

Bill Rotatori, president of GR-NEAM, agrees, and cites solvency modernisation initiatives from the US National Association of

Insurance Commissioners as proof of this progress.

“A lot of other insurance centres are making regulatory equivalence efforts and that’s changing the rules,” he says. However, he adds with concern that this may only further an atmosphere of uncertainty in those territories around what insurers can do with assets and what the impact around capital requirements will be. The key objectives should be to achieve a regulatory framework that is consistent, and not contradictory to, an effective capital management process, he says.

For now, however, the difference in regulatory regimes remains, and therefore the pressures around the world remain similarly divergent.

“In Europe the ability to pick up yield and income in private or more illiquid type investments has very significant regulatory pressure on it...that spectre of Solvency II is putting a very significant pressure on portfolios and future investment policy in Europe,” says Malloy.

“That does not seem to be central to the dialogue with North American companies as yet.”

As a result, he notes that there is a far more immediate focus to the strategy of asset managers in North America, which allows for insurers to ask the questions about yielded income to support return objectives that their European counterparts have been forced to forego.

With so much about the final form of regulation still uncertain, the role of asset managers in the equation is likely to maintain its importance, particularly for insurers who need assistance to decode the various intricacies.

“There will be, no doubt, more evolution in the regulation and more detail in how the regulations are applied and what the implications are for investment strategies and for capital,” says Bradford at Conning.

“And so for us, our clients are asking us: where could this go, what are the range of outcomes that could happen, how do we position ourselves for it and what do we need to do to prepare?”

For Rotatori, the challenges of Solvency II represent an addition to the financial backdrop of low yields and attempts to generate returns on capital. Each of these, he says are rapidly evolving and represent a dynamic process, though he welcomes the clarity that will, at least, come with the finalisation of capital rules.

“It’s not something that’s a one-time exercise...it’s something you need to continue to assess,” he says.

“Capital market conditions will continue to change but as the details of Solvency II get finalised you begin to get a little more firm ground under your feet about the things you can do and the right thing to do for company portfolios.”

As a result, he stresses that there is a need to view the entire picture, as well as the challenges posed by Solvency II, and for insurers to be actively involved in the decision making around their asset management.

Indeed, there is a wide recognition among the asset managers Reactions spoke to that insurers have been making far greater strides to understand and advance their asset management strategies at board level, perhaps as a result of these stimuli.

“I think we’re just in unusual times,” says Rotatori. “We haven’t seen these yield levels in 50 years and we haven’t seen the developed world deal with these sorts of debt levels before or these very unusual fiscal and monetary stimulus situations.

“Unusual situations require a little more engaged thinking and a little more consideration of alternatives, it’s just good active engagement I would say.”

By Mark Sands – msands@euromoneyplc.com