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Research Update

February 2015

Solvency II asset look through
Challenges & Solutions

This research is specifically for Finance, Actuarial, Legal, Operations, Risk Management, Compliance and Audit personnel working on Sol II projects now...

George McCutcheon MSc FIA
discusses Solvency II asset look-through

Overview

Following the publication of Set II of the Implementing Technical Standards for Solvency II QRTs, there is now more clarity on the application of look-through for asset reporting. In this research update, George McCutcheon examines this issue in more detail.

Key messages for life insurers

Requirements

- The Solvency Capital Requirement (SCR) is required to be computed on a look-through basis
- Under Solvency II, life insurers have a 'know your assets' requirement on an economic substance basis i.e. irrespective of whether assets are held directly or indirectly through **Collective Investment Undertakings (CIUs)**
- Look-through is not optional e.g. it is required for the Pillar 2 system of governance requirements and the Pillar 3 reporting Assets D4 QRT
- The exemption from quarterly reporting of the assets D4 QRT for insurers with less than 30% of their investments in CIUs doesn't exempt such insurers from the ongoing risk management system of governance requirements and from the quarterly market risk SCR calculations on a look-through basis
- Whilst the market risk SCR calculation for unit-linked business takes full account of the level of unit matching, there is no distinction in the Article 132 requirement to 'know your assets' between investments where the entity has the economic exposure and unit-linked investments where customers have the economic exposure.

Capital Management

- If life insurers can't apply look-through for SCR calculations, they will have to hold higher capital as their SCR will be unduly inflated by having to treat their holdings in CIUs as type 2 equities.

Challenges

- Look-through requires a fundamental change in mind-set for insurers and presents a real challenge for their risk management and compliance functions
- This is likely to lead to market upheaval and proposition restructuring e.g. where investment products with opaque investment structures might be considered to be incompatible with the Article 132 principles
- Look-through generates additional workload for insurers with potentially significant impacts on reporting timetables

Issues

- The same standards of governance apply equally to unit-linked business and other business lines and this has potentially significant litigation risks for insurers in respect of unit-linked investments
- Life companies should consider the use of third party data aggregators to source asset look-through data
- Implementation of Pillar 2 system of governance and Pillar 3 asset reporting is not easy and will require investment in new technology such as Invest|GRC™, an FRS dedicated Sol II asset warehouse and QRT reporting tool
- In an environment of increasing outsourcing by insurers of investment administration, the availability to the insurer's Solvency II risk management and compliance functions of browser based analytics capabilities with real-time unfettered access to asset data is of paramount importance.

Benefits

- Look-through doesn't just mean extra costs to meet reporting requirements. There are also benefits to life insurers from deploying look-through capabilities.
- Look-though will enable insurers to gain greater control and insight into their asset portfolio and thus help enhance their enterprise ability to mitigate the risk exposure of their investments through their Solvency II risk management and compliance functions
- Better quality fund factsheet information for customers will be facilitated by look-through

- Asset managers need to consider whether their approach to Solvency II represents a strategic objective for their organisation or is simply a minimum work approach to meeting a new regulatory requirement for their insurer clients

Asset managers unable to facilitate look-through risk losing their mandates from insurers. Conversely those offering top Sol II service may win more and new mandates

- CIU asset managers need to understand the needs of their insurer clients. Does the insurer merely want to generate the asset D4 QRT or does the insurer also want to do SCR calculations on the CIU data?
- Life companies will want to discuss with the asset managers of their CIUs the mechanisms for obtaining the required asset data
- Asset managers should consider the use of third party data aggregators to provide look-through data to their insurer investors
- Asset managers will need to invest in new dedicated technology tools to meet the needs of their insurer customers in this new Sol II world

Key messages for asset managers

- The introduction of Solvency II for insurers may be a 'disruptive event' for asset managers with winners and losers
- Look-through reporting of asset data is a regulatory requirement for EU insurers under Solvency II
- The Pillar 3 reporting look-through Asset D4 QRT is not optional or a 'nice-to-have'. It is the new Sol II regulatory law

Next steps for asset managers

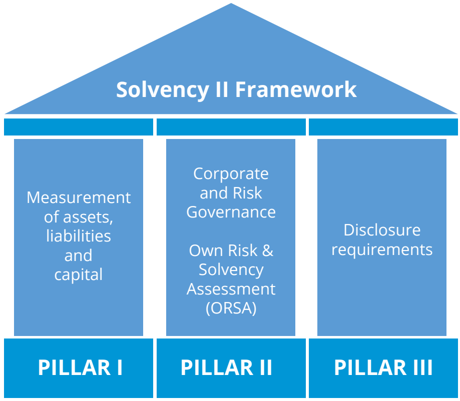
- An urgent internal Sol II readiness assessment is required well in advance of the Solvency II implementation date of 1/1/2016 to make sure you are satisfying existing insurance clients and attracting new mandates using the latest practices and technology to win new mandates
- Make sure your key insurance client-facing colleagues are right up to speed on insurers' Solvency II needs from asset managers

Solvency II Background

After a number of delays, Solvency II comes into force from 1 January 2016.

EIOPA has developed Guidelines[1] and Implementing Technical Standards (ITS)[2] based on the Solvency II Directive 2009/138/EC. Public Consultation on Set 2 of the Solvency II Implementing Technical Standards and Guidelines has commenced with comments due by 2 March 2015.

Pillar 3 consultation includes CP-14/052 (27/11/14) in the ITS for the templates for the submission of information to the supervisory authorities.



Background to asset look-through

The origins of asset look-through lie with Article 132 (the Prudent Person Principle) of the Solvency II directive which requires that insurers shall only invest in assets whose risks they can properly identify, measure, monitor, manage, control and report (IMMMCR) and appropriately take into account in the assessment of its overall solvency needs.

IMMMCR

- The 'identify' part recognises that investments need to be monitored based on their economic substance irrespective of the legal form of the investment and that will require look-through of CIUs.
- The 'measure' part and the taking into account in the assessment of its overall solvency needs is covered by the market risk SCR calculations
- The 'monitor, manage, control' parts are covered by Pillar 2 system of governance
- The 'report' part is covered by the assets QRTSs and in particular assets D1 and assets D4.

Three strands to asset look-through
- ***Pillar 1 SCR calculations***
- ***Pillar 2 system of governance requirements***
- ***Pillar 3 asset reporting***

Unit-linked business

In pre-implementation submissions, insurers had argued for certain exemptions for unit-linked business from the enabling provisions for Article 132 on the basis that risks have been boxed off if insurers have matched unit positions.

EIOPA have taken a different view in that Article 132 doesn't consider unit-linked business to be different from other business classes.

Furthermore Article 132 has a requirement that investments be selected in the best interest of policyholders and that would require that the insurer have a full understanding of the inherent risks on an economic substance basis. Whilst the market risk SCR calculation for unit-linked business takes full account of the level of unit matching, there is no distinction in the Article 132 requirement to 'know your assets' between investments where the entity has the economic exposure and unit-linked investments where customers have the economic exposure.

This implies that the same standards of governance are required and this has potentially significant litigation risks for insurers in respect of unit-linked investments that encounter difficulties.

[1] Guidelines are non-binding instruments drafted by EIOPA addressed to National Competent Authorities (NCAs) or Financial Institutions, with the aim of ensuring the common, uniform and consistent application of Union law as well as with a view to establishing consistent, efficient and effective supervisory practices in accordance with Article 16 of the Regulation establishing EIOPA

[2] Implementing Technical Standards are regulatory tools drafted by EIOPA in accordance with Article 15 of the Regulation establishing EIOPA

Unit-linked companies with matched unit positions

The requirement to compute the market risk SCR on a look-through basis is a much less consequential issue for unit-linked life companies with matched unit positions.

More clarity is required on the Prudential Regulatory Authority interpretation of the definition of technical provisions for the close matching rules (COBS 21.2.2R) in the context of the Article 132(3) Solvency II requirement for unit-linked contracts that the technical provisions in respect of those benefits must be represented as closely as possible by those units

http://www.actuarialpost.co.uk/article/clarity-required-for-unit-matching-rules-under-solvency-ii-7134.htm

There are various capital management initiatives that life insurers can take.

http://www.actuarialpost.co.uk/article/minimising-volatility-of-solvency-ii-funds-and-reducing-scr-7167.htm

Implementing asset look-through

One of the more problematic aspects of Solvency II for insurers and asset managers alike is the principle of look-through where insurers with holdings in investment funds are required to 'look through' the funds and report (the Assets D4 QRT) on asset category, geographical exposure and currency exposure of the underlying assets. There raises the practical issue of the complexity of obtaining the relevant data, especially for funds of funds.

Insurers have placed short-term focus on the Pillar 3 requirement for the assets D4 QRT and the Pillar 1 market risk SCR calculation on a look-through basis. However the real challenge is to implement the IMMMCR (identify, measure, monitor, manage, control and report) requirements of Article 132 i.e. for insurers to 'know their assets'.

Life insurers – why apply look-through?

Life insurers can reduce capital requirements by applying look-through

Asset look-through is not optional.

For the SCR calculation, look-through is required but in default where the look-through approach cannot be applied (e.g. non-provision of data by a CIU) there are specified alternative approaches but which would involve capital hits.

If life insurers can't apply look-through for SCR calculations, they will have to hold higher levels of capital as their SCR will be unduly inflated by having to treat their holdings in CIUs as type 2 equities i.e. a form of punishment for non-compliance.

Thus for those life insurers where capital efficiency and availability is critical, a compelling motivation to implement the data management systems required to fulfil the look-through principle would be the resulting reduction in solvency capital requirement (SCR) and minimum capital requirement (MCR).

The Pillar 3 reporting look-through Asset D4 QRT is not optional or a 'nice-to-have'. It is the new Sol II regulatory law.

Solvency II reporting

The Solvency II balance sheet reporting does not apply on a look-through basis. For example assets held for unit-linked or index-linked contracts are shown as a single item under R0220 and investment funds (other than assets held in respect of unit-linked or index-linked contracts) are shown as a single line under R0180.

However look-through is required for Assets D4 and is needed for SCR calculations.

SCR

SCR is calculated on a look-through basis

According to Article 84 of the Implementing Measures undertakings in calculating the SCR have to apply the look-through approach to collective investment undertakings, other investments packaged as funds and also in respect of indirect exposures to market, counterparty and underwriting risk.

Per Article 84(3), where the look-through approach cannot be applied to CIUs or investments packaged as funds, the SCR may be calculated on the basis of the target underlying asset allocation of the CIU or fund, provided

- Such a target allocation is available to the undertaking at the level of granularity necessary for calculating all relevant sub-modules and scenarios of the standard formula
- The underlying assets are managed strictly according to this target allocation.

For the purposes of that calculation, data groupings may be used, provided they are applied in a prudent manner, and that they do not apply to more than 20 % of the total value of the assets of the undertaking.

Otherwise they are classified [3] as type 2 equities with adverse consequences. The capital requirement for type 2 equities referred to in Article 168 of the Regulation is equal to the loss in the basic own funds that would result an instantaneous decrease equal to the sum of 49 % and the symmetric adjustment as referred to in Article 172.

Asset QRTs

Name	Ref	Description	Quarterly	Annual
Asset Summary	S.06.01			✓
Assets - D1	S.06.02	List of investments	✓	✓
D1S	S.07.01	Structured products		✓
D2O	S.08.01	Derivatives data – open positions	✓	✓
D2T	S.08.02	Derivatives data - historical derivatives trades	✓	✓
D3	S.09.01	Income, gains and losses	✓	✓
D4	S.06.03	Investment funds (look-through approach)		✓
D5	S.10.01	Securities lending and repos		✓
D6	S.11.01	Assets held as collateral		✓
Total			**4**	**9**

[3] Type 2 equities shall also comprise all assets including the assets and indirect exposures referred to in Article 84(1) and (2) where a look-through approach is not possible and the insurance or reinsurance undertaking does not make use of the provisions in Article 84(3).

Assets D4 QRT

> ***EIOPA believe Assets D4 to be essential for better understanding of insurers' investments through investment funds***

This is a report on asset category, geographical exposure and currency exposure of the underlying assets.

At an earlier stage, it was envisaged that this report would be at internal fund level but the latest version envisages a report at aggregate level i.e. the 'Total amount' is the insurer's aggregate holding with no regard to the 'Portfolio' or 'Fund number' of Assets D1.

This change has no implications for the form of data provided by asset managers to insurers.

S.06.03.a

Collective investment undertakings - look-through approach

Collective Investments Undertaking ID Code	Collective Investments Undertaking ID Code type	Underlying asset category	Country of issue	Currency	Total amount
C0040	C0050	C0060	C0070	C0070	C0090
A1	A2	A4	A5	A5	A7

The asset categories referred to in this template are the ones defined in Annex III – Assets Categories of the Regulation. Currency is 1 for reporting currency and 2 for foreign currency (the return will thus differ between UK and non-UK insurers).

In practice, asset managers would supply information at security level and insurers would collate at asset category level. CIU asset managers need to understand the needs of their insurer clients.

Does the insurer merely want to generate the asset D4 QRT or does the insurer also want to do SCR calculations on the CIU data?

If it's the latter, it's not just about the CIU asset manager providing a schedule of assets but also about enriching the data with the security level parameters needed for SCR calculations. It might also be about the CIU asset manager performing the market risk SCR calculations also.

Quarterly reporting of Assets D4 is only required from undertakings that hold more than 30% of their portfolio in CIUs but annual reporting is required from all insurers regardless of materiality. Assets D4 is not part of the submission of information during the preparatory phase.

Benefits from Assets D4 QRT

The benefits for supervisory purposes and policyholder protection come from the fact that the look through approach, being a requisite of the Solvency II Directive, provides a greater insight on the undertaking' risk profile, through main types of investment, that is not fully captured under the detailed list of investments (AS-D1).

EIOPA believe that it is essential for insurers to properly assess and manage the risks embedded in investment funds.

Confidentiality issues

There is no public disclosure of the assets D4 QRT i.e. no disclosure of assets data on a look-through basis into the public domain or media.

Practical issues for life insurers

A PRA Solvency II regulatory reporting industry working group identified differences on levels of detail accessible when the asset manager is external vs. internal to the firm and highlighted particular challenges in gathering asset data on fund of funds more than a single layer down when the asset manager is external.

Guidelines on look-through approach

Under guideline 2, undertakings should perform a sufficient number of iterations of the look-through approach, where appropriate (e.g. where a fund is invested in other funds) to capture all material risk.

Risk management and compliance functions

> ***The risk management and compliance functions will need browser based unfettered access to real-time investment data on a look-through basis***

A crucial component of the technological solution will be the seamless transfer of data between asset managers (and on a continuous basis and not just quarterly for QRTs and SCR calculations).

The proposed exemption from quarterly reporting of the assets D4 QRT for insurers with less than 30% of their investments in CIUs doesn't exempt such insurers from the ongoing risk management system of governance requirements and from the quarterly market risk SCR calculations on a look-through basis.

This technological solution will empower the risk management and compliance functions providing them with the data that they require and in the format that they need i.e. powerful analytics capabilities with customised dashboards, rules and breach monitoring. This empowers risk and compliance personnel to do their job. This will also provide the required datasets for the regulatory QRTs.

Benefits from look-through

The benefits to insurers from the application of look-through will include:

- Better understanding and control of market risks.
- A thorough knowledge of the risks underlying each investment may allow insurers to properly manage their overall exposure and thus better manage capital
- Look-though will help enhance their enterprise ability to mitigate the risk exposure of their investments through their Solvency II risk management and compliance functions
- Better quality fund factsheet information for customers will be facilitated by look-through
- Solvency II will significantly increase the quantity and quality of data managed and exchanged between asset managers and insurers.

Provision of data by asset managers

> ***Asset managers will need to provide look through assets data to insurers***

Life insurers with holdings in collective investment undertakings will not be able to generate the required regulatory QRT Assets D4 without the provision of look-through data by asset managers. In the event that such asset data is not available from asset managers, life insurers will come under regulatory pressure to move their investments in such CIUs to other asset managers.

Asset managers – is the approach to Solvency II strategic?

> ***Is the asset manager's approach strategic? Will it help win more insurance mandates?***

Asset managers need to consider whether their approach to Solvency II represents a strategic objective for their organisation or is simply a minimum work approach to meeting a new regulatory requirement for their insurer clients.

There should be a properly evaluated choice by the asset manager about the role of Solvency II in its business.

The asset manager's approach to Solvency II will help shape their insurance clients' expectations on the ability of the asset manager to partner with them on addressing the new regulatory issues. For some asset managers, simply meeting minimum requirements may be as far as they are willing to go. The approach of the asset manager will have implications for the level of engagement required for both its insurance clients and its internal processes including scalability and the on-boarding of new insurance client mandates.

Asset managers – practical issues

Solvency II regulation requires 'look-through' functionality to reveal the full exposure of CIU holdings. This creates a challenge for asset managers in terms of liaison with other asset managers and the timeliness of the data required.

- A PRA Solvency II regulatory reporting industry working group identified differences on levels of detail accessible when the asset manager is external vs. internal to the firm.
- There is significant cross-investment between asset managers. Gathering asset data on fund of funds more than a single layer down is a challenge.
- Active managers will want to protect their IP. The solution can't require asset managers to share confidential information with their competitors.
- IP must be protected while achieving the right balance between the need of insurers to feed timely data into their risk assessment models, the requirement to provide sufficient time for the data to be reviewed before filing with the regulator and the desire by asset managers to apply embargoes. This is not an insurmountable challenge provided that appropriate non-disclosure agreements and secure data exchange channels are put in place

> ***Will Solvency II provide disruptive opportunities?***
>
> ***Will it provide an opportunity for asset managers to consolidate more funds from existing insurer clients?***
>
> ***Would the capability of the CIU asset manager to generate market risk SCR calculations be a game-changer?***

- What level of compromise on formats, embargos and delivery channels will asset managers entertain? Failure to properly engage could lead to frustration and some level of disillusion for their insurer clients. Enlightened asset managers will seek to maximise client satisfaction while keeping their response as standard and cost-effective as possible.
- The level of granularity encouraged by the look-through principle means that holdings data must be clear, regular, and wholly reliable which means automated systems are needed.
- To add to the complexity of the situation, some of the reports and data items are still to be clarified.
- Solvency II look-through implementation requires a simple cost-effective solution that facilitates both the delivery and receipt of data in a standard format.

Asset managers – commercials

It is currently unclear who will bear the brunt of the costs to produce the information required by the regulator.

Competitive tensions are increasing the pressure on asset managers to provide look-through data and to absorb some of the associated costs.

Asset managers are facing some interesting questions.

- Do they provide the Solvency II data requirements as a value-add service? What other regulatory costs will be coming their way in future?
- Do they fully appreciate the implications and costs associated with providing this service?

Some new services are springing up to provide solutions for insurers, but the costs are often being pushed towards the asset managers while the responsibility remains firmly with insurers. It is quite likely that as a result of Solvency II regulation, some insurers will seek to reduce their number of asset managers.

Some asset managers may focus on non-insurance business but given approximately 45% of European asset managers funds are sold to insurers this is an important decision.

Data exchange

The adoption of a look-through approach generates additional workload for insurers in the areas of data collection, data enrichment, data harmonization, data consolidation and reporting.

Life insurers will need data from multiple asset managers in respect of the required asset data in CIUs. Conversely asset managers will need to provide asset data to multiple life insurers.

There is a need to standardise the format of data exchanges through the creation of standard templates. Life insurers will have to use a combination of

- Data direct from asset managers
- Data via data aggregators with fund reporting utility tools

For some life companies, acquiring timely, clean, and accurate data from multiple asset managers will be an unrealistic undertaking and they will instead chose to use the services of third party data providers.

Data aggregators

The required source data will involve different jurisdictions, different asset classes and pooled vehicles via multi-managers and other third parties. The most efficient way to process this will be a central, consolidating data warehouse covering all the linkages and the feeds from various sources. Data will have to be tested, consolidated and enriched. An independent entity is arguably best placed to consolidate and verify asset data before it is released in a consolidated and consistent format to the client.

A number of vendors are offering an investment fund look-through for Solvency II.

The concept is that such a reporting utility provides asset managers with permissioned and controlled Solvency II reporting to insurance investors, and provides insurance companies with timely access to fund holdings positions from a single source and in a standardized format.

There are a number of commercial models- the asset managers pay for the facility; the life insurers pay or a combination of both.

Investment Template

The Investment Management Association (IMA) in the UK, BVI in Germany and Club AMPERE, sponsored by the French Asset Management Association (AFG), have established a template for Solvency II reporting.

The objective of the template is to facilitate the SCR calculation under the standard formula (standard model) and to support data delivery for QRTs. The template is intended to ensure that asset managers choosing to use the template should meet the new Solvency II reporting requirements when they come into force on 1 January 2016.

The initiative aims to help standardise the transfer of data needed for SCR calculation and look-through by creating a common set of definitions and interpretations of the required data fields.

The associations said that standardising the format of data exchange should create operational efficiencies, increase the accuracy and reliability of data and reduce operational risk and cost.

Technology Solutions

Invest|GRC™ (Governance, Risk & Compliance). This is an asset reporting product that can consume data from the company's primary investment and financial system, outsourcers and from other external data sources. It empowers senior finance, risk, audit, ops and admin staff to monitor risks and mandates, do rules management, see breach occurrences assist corrections and importantly produce asset reports (both regulatory reports including for insurance clients and also risk management function reports). There are three main strands: 1. Solvency II asset QRTs, 2. Risk management metrics, rules monitoring, breach management and compliance and 3. Analytics.

Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS). He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland.

About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund administration software to the life assurance and pensions industries. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund administration area and customers in life assurance and third party administration include MetLife, Zurich, Aegon, SEB, Charles Taylor, IFDS, and Accenture Managed Services.

Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, investment accounting, tax, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds and with-profit funds. Invest Pro™ was specifically designed to securely automate complex fund administration processes.

Invest|OPS™ (Outsourcing Partner Supervision) automates the validation of operational activity performed by outsourcing partners. It provides methods for assessing the standard of performance of the service provider; enables the investment firm to supervise the outsourced functions and to manage the risks associated with outsourcing. It also provides the firm with effective access to the data associated with the outsourced activities.

Invest|GRC™ (Governance, Risk & Compliance). This is an asset reporting product that can consume data from the company's primary investment and financial system, outsourcers and from other external data sources. It empowers senior finance, risk, audit, ops and admin staff to monitor risks and mandates, do rules management, see breach occurrences assist corrections and importantly produce asset reports (both regulatory reports including for insurance clients and also risk management function reports). There are three main strands: 1. Solvency II asset QRTs, 2. Risk management metrics, rules monitoring, breach management and compliance and 3. Analytics.

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