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Asset management and funds

Briefing note

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Investments by Insurers under Solvency II

1 January 2016 saw the implementation across Europe of the Solvency II regulatory regime for insurers. Under Solvency II, the treatment of investments by insurers has changed and extensive new reporting requirements have been introduced. These changes represent potential opportunities as well as challenges for asset managers in their relations with insurer clients/ investors.

This briefing outlines some of the new Solvency II requirements from an investment and a reporting perspective.

Investments under Solvency II

Under Solvency I (before Solvency II), whilst there were no rules prohibiting insurers from investing in specific assets, only investments in assets from a list of "admissible assets" could count towards an insurer's capital requirements. This meant that, in practice, the majority of insurers' investments were in "admissible assets". Insurers then had to take into account in their capital calculations deductions for excess counterparty or asset exposure.

Under Solvency II, the "admissible asset" concept and counterparty/ asset limits no longer exists. Insurers instead have to calculate their Solvency Capital Requirement ("**SCR**"), on the basis of a number of risk modules including market risk, which sets the capital charge applicable for individual investments. The market risk module accounts for a large percentage of an insurer's capital charge, particularly for life insurers, and effectively assigns risk weightings to equity, property and

Key changes

The main changes under Solvency II from an investments perspective are:

- a change to the approach to investments - doing away with the list of "admissible assets" under Solvency I and replacing it with a risk-based approach involving capital requirements on the asset side of the balance sheet. The regime includes a requirement for investments to be made in accordance with the Prudent Person Principle ("**PPP**") and for investments in collective investment undertakings and funds to be made using a "look through approach" to underlying assets in the funds, rather than, as previously, focusing on the type of fund;
- increased reporting requirements for insurers on their investments, including in relation to investments in collective investment undertakings and funds, to satisfy the look through approach. This means that insurers are requiring greater detail and more frequent reporting from asset managers on their investments.
- material investment management agreements ("**IMAs**") are likely to be considered material outsourcing arrangements, which will need to satisfy the new outsourcing requirements under Solvency II (although this note does not consider the outsourcing requirements in detail). Asset managers may be asked to revise existing IMAs to make them Solvency II compliant, and similarly insurers will wish to ensure new IMAs are Solvency II compliant.

debt based investments. The capital charge provisions under the default "standard formula" are set out in the relevant Solvency II regulation.

However, a large number of the larger insurers have developed and adopted their own tailored "internal models" or "partial internal models" designed to take into account the risks inherent in that insurers' own portfolio of business. The capital charge of investments for insurers on "internal models" may well vary from those on the standard model. Asset managers may therefore wish to check if their insurer clients have adopted internal models and, if so, would need to work with the insurers to structure investments appropriately. The combination of the use of internal models and matching adjustment compliant investment portfolios may point towards insurers requiring bespoke investment structures and strategies going forward.

Prudent Person Principle

Solvency II also requires insurers to invest all their assets in accordance with the prudent person principle ("**PPP**"). This includes the requirement on insurers to invest only in assets and instruments:

1. whose risks can be properly identified, measured, monitored, managed, controlled and reported;
2. that ensure the security, quality, liquidity and profitability of the portfolio as a whole;
3. that are appropriate to the nature and duration of insurance and reinsurance liabilities; and
4. in the best interest of policyholders and beneficiaries.

Look-Through

Insurers investing in funds are required to adopt the "look through approach" in calculating their SCR. This means that the SCR will generally need to be calculated on the basis of the underlying assets in a fund structure and this approach will need to be applied a sufficient number of times to capture all material risk. This also means that where an insurer invests in a fund of funds or a feeder/ master fund structure, it will need to "look through" each fund and sub-fund so that the SCR is calculated on the ultimate underlying assets in so far as possible.

Where the look through approach is not possible, an insurer may be able to calculate its SCR on the basis of the investment policy of the fund, provided this is strictly adhered to. Insurers would therefore look to invest in funds where the investment policy is sufficiently clear and specific (and may insist on writing their own investment policy), in order to apply the look through approach and understand the underlying material risks.

Insurers will also require adequate reporting on the funds to apply the look through approach. If the look through approach cannot be applied (whether because of the investment policy or inadequate reporting), then the investment may need to be treated as equity (at a 49% charge for unlisted equities), which is unlikely to be attractive to insurers. In order to encourage investment in certain types of funds, the European insurance regulator ("**EIOPA**") has prescribed the listed equity capital charge of 39% for equities whether or not listed but which are invested in through certain funds (including equities in a European Long Term Investment Funds ("**ELTIF**")) and a 30% charge for qualifying infrastructure investments.

Reporting Requirements under Solvency II

Solvency II increases data and reporting requirements on insurers both in detail and frequency. In turn, insurers will require asset managers to provide appropriate reporting to insurers on their investments. However, in providing the data and reporting required by insurers, asset managers will wish to ensure that proprietary and confidential information on their funds and investment strategy are kept confidential and the risk of "alpha-tracking" of a fund's strategy is minimised. This may be particularly sensitive when the insurer investor is also a competitor or owns a competitor of the asset manager. The use of non-disclosure agreements ("**Solvency II NDAs**") assists in protecting the asset manager's position.

Data quality

Data used by insurers under Solvency II is required to be accurate, complete and appropriate. Data must meet the same quality standards irrespective of whether it is sourced by the insurer internally or externally. As such, there is likely to be additional pressure on asset managers from insurer clients requiring assurance in respect of the quality and consistency of data reported. An asset manager may agree to provide comfort to an insurer by providing access to insurers to allow due diligence of certain relevant internal processes and controls (which may include a site visit).

To relieve the data quality and cost burden imposed by Solvency II, asset

managers may wish to consider contracting a third party that can provide the look-through transparency to fund positions. These third parties can provide a ‘data file’ with quantitative data that can be used to meet the relevant Solvency II reporting requirement. The type of data in the 'data file' will depend on the type of insurance client and assets managed, however, in summary may include some or all of the following:

- pooled fund look-through data;
- holdings data in segregated accounts;
- position data;
- gain / loss accounting data; and
- certain SCR calculations for assets held.

Increased frequency

Insurers are required to report more frequently and within short timescales under Solvency II. Quantitative reporting templates ("**QRTs**") are required to be completed and submitted quarterly, as well as annually, within five to eight weeks of the end of the quarter. In addition, insurers are required to update their own risk and solvency assessment ("**ORSA**"), following any significant change in the insurer's risk profile which must be submitted to the regulator within 2 weeks of the conclusion of the assessment. Insurers will therefore require their asset managers to provide full asset information promptly upon the end of each quarter and financial year as well as between quarters in the event of an updated ORSA being required.

Additional Requirements

In addition to the Solvency II reporting requirements, insurers are also likely to require additional reporting which is bespoke and will require close interaction between insurer and asset manager. For example, an insurer may want to have its internal model assumptions reflected in the reporting that an asset manager provides.

Timescales for reporting that most insurers will require are also, in practice, likely to be more onerous than the basic requirements under the regulations. Most large insurers may require reporting within days rather than weeks after the period end.

How we can help

Our leading global corporate insurance practice regularly advises the world's insurance and reinsurance companies on a full range of areas including M&A and other corporate transactions as well as Solvency II and other financial services regulation. Drawing on their in-depth knowledge of the insurance industry, the insurance practice works closely with our London Asset Management Practice in advising on investment structures, fund formation and other aspects of asset managers' relationship with insurers.

Our London Asset Management Practice consists of funds, regulatory, tax and corporate lawyers who regularly advise on investment products including fund formation and structuring solutions, to help accommodate the investment requirements of insurers under Solvency II.

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