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Solvency II: rethinking the debt portfolio

Financial engineering can help to optimise insurers' fixed income strategies

Key takeaways:

- To enhance yield, many insurers are starting to look at unconventional strategies, such as debt backed by real assets which attracts a low Solvency Capital Requirement under the Solvency II Directive.
- Portfolio managers must incorporate SCR constraints into allocations for insurers, which makes portfolio construction a much more complicated process.
- Asset managers and insurers can work hand-in-hand to reshape mandate guidelines, create new modelling capabilities and develop new asset classes.

Solvency II has a major impact both on the assets insurers can hold and on how their investments are recorded and reported.

Not only all assets have to be purchased or sold with the Solvency Capital Requirement (SCR) firmly in mind, but the quantity and quality of data delivery about those assets must increase significantly.

In essence, each time insurers take a position they have to know not just the likely return from the asset, but how it impacts the insurer's capital position. This entails complex scenario testing and modelling around both the asset and the wider portfolio.

Increased attractiveness of alternative debt

Considerable modelling is required to manage the necessary transition in asset allocation. Insurers need fixed income assets with long durations in order to minimise the capital cost of interest rate risk of their long-term liabilities.

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With this in mind, the most favoured asset class is clearly long sovereign bonds, which also help to keep the overall fixed income duration in line with liabilities. Sovereign debt is likely to be employed together with short-term corporate bonds, which are not overly penalized by the SCR because of their short duration.

But neither of these debt instruments solve the thorny problem of yield. To enhance yield, many insurers are starting to look at a variety of relatively unconventional strategies. These include less liquid strategies such as private corporate debt, and commercial real estate loans, and alternative long duration assets such as infrastructure debt, residential mortgages, export credit agencies and supranational debt.

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Debt backed by real assets is particularly attractive. While securitised debt – such as CLO and ABS - is heavily penalised under SII, real assets attract a relatively low SCR. For example, the SCR of infrastructure debt is considerably lower than standard debt of the same maturity. Although liquidity and availability limits the weight of infrastructure debt in the strategic allocation, it is a good diversifier as well as a yield-enhancer.

The SCR for unrated real asset debt (real estate and infrastructure) is lower since it is collateralized by the underlying asset. The SCR for real estate debt can be reduced by as much as half if the value of the collateral is high compared with the value of the loan.

Asset managers must bring new skills to the table

In periods of low interest rates, the attractiveness of alternative asset classes with relatively higher spreads increases. However, these asset classes require large research capabilities to source the investment opportunities and to price and evaluate the risks. They also require considerable implementation skills. Under SII, asset allocation depends not just on the attractiveness of the assets, but on the structure of insurer's liabilities and on the cost of capital.

This means insurers must have a detailed understanding of their assets and liabilities. They also have to know both their marginal cost of capital, their global cost of capital and must be able to define their risk appetite. Strategic allocations become therefore more refined and more dynamic.

In this developing scenario, asset managers have a new role in helping insurers refine their decision-making processes - taking into account their expected investment returns, their profitability targets and their risk limits.

Asset managers may even be able to contribute to the design of the insurer's internal models. Asset managers' experience of modelling and valuing financial instruments can be valuable in designing the part of the model that relates to assets. In order to reinforce this relationship, asset managers increasingly review their funds and mandates in order to meet insurers' requirements in terms not just of investment strategies but of data too - quality, delay, traceability.

Applying quant to portfolio construction

The complexity of the task at hand puts increasing emphasis on quant approaches. A quant approach can accurately match assets to liability flows and help set SCR budgets. Insurers are now expected to be able to calculate the impact under the standard formula, ex post and ex ante, on the SCR of all their investment decisions. Natixis Asset Management's quantitative research and analysis team maintains a continuous dialogue with insurers, helping them to find the right asset mix to optimise the portfolio, taking into account SCR constraints and budgets.

Portfolio construction must take into account the cost of capital, she says, and each strategy must be analysed as a function of expected return, of incremental risk to the portfolio and of capital consumed.

NAM's quant team has two inter-related roles: firstly to help develop and refine debt strategies that are best suited to investors - in particular insurers operating under SII - and secondly to help implement these strategies in the portfolio to maximise returns and optimise the assets under SII.

In its first role, it provides economic and quantitative input to all investment management teams and specialist committees to help them elaborate their opinions and refine their strategies. For each new portfolio strategy, the quant team works with the portfolio managers to establish risk and performance targets, and which tools are required to build the portfolio.

The quant team calibrates risk-return expectations by back-testing strategies, modelling portfolios and developing pricing models.

In its second role, it uses proprietary optimizers and internal simulation modules to perform risk-assessment or stress tests. It can compute the capital requirements of any debt asset class across different maturities and characteristics, and analyse the potential yield over multiple timeframes.

Reporting is now part of the investment proposition

In terms of reporting, the new regulations set high standards that only quant techniques can adequately meet. Classic inventories of portfolio investments are no longer sufficient and need to be expanded so that insurers can identify broad exposures to different markets and issuers.

The asset management industry has responded to the reporting challenge by initiating standardisation. Industry representatives in France (AFG, Club Ampère), Germany (BVI) and the UK (IMA) have published a detailed inventory template which should help standardise the presentation of information.

Quarterly reporting templates are useful in assessing whether the required data exists within the organization and, if so, whether it is readily accessible.

One of the pinchpoints in reporting is pooled vehicles. SII applies the look-through principle in terms of data disclosure, which is problematic for insurers which invest through pooled vehicles. But solutions can be found. To report risks embedded within portfolios, asset managers should be able to provide a variety of risk metrics that capture a portfolio's risk characteristics without the need for granular disclosure.

Designing SII-compliant products

Expanded reporting under SII not simply results in changes to back office processes – it also demands a deep rethink of investment products and how they can best serve institutions captured by SII.

To put it simply, SII doesn't like complexity and punishes insurers which invest in strategies which the Directive considers unnecessarily complicated.

In some cases, this means strategies must be redesigned or entirely new products created.

As a rule, investments must be transparent, allowing reporting to be simple, but detailed. This heavily penalises funds of funds, for instance, which have a very large number of reporting lines, make it difficult to retrieve data and can have a number of differing valuation methods from different providers. Products aimed at investors under SII must prioritize transparency and direct holdings. A simple example of such an adaptation is money market funds, which frequently invest in other money market funds to manage their cash positions. Direct investing can significantly reduce the size of inventory reports and reduce the SCR.

Conclusion – a partnership approach

The data requirements of SII are undeniably significant. However, now that the administrative costs and changes to information systems have to a large extent been absorbed, asset managers and insurers can work hand-in-hand to revisit mandate guidelines, create new modelling capabilities, and develop new asset classes. More than ever, a partnership approach is the key to building portfolios that deliver against liabilities and help insurers raise their profit margins.

Find out more about the impact of Solvency II on debt markets in reading the whitepaper by the Natixis Asset Management's quantitative research and analysis team.

Written on 2 March 2017

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