Focus: Effective asset management under Solvency II

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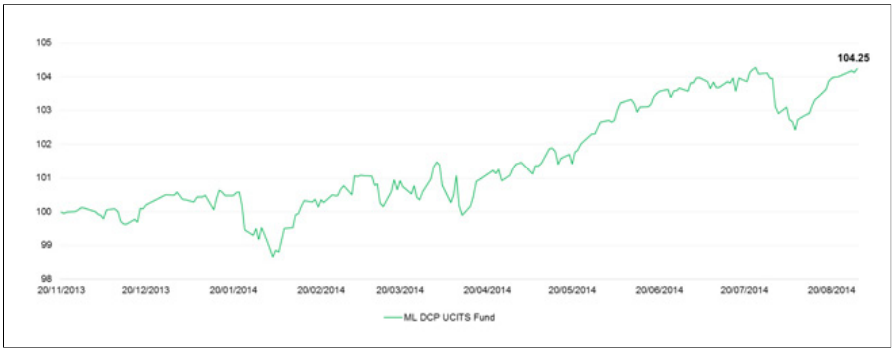
Learning from the insurers *- As Solvency II regulations are soon to be launched for the insurance industry, Sandra Haurant explains why pension funds should be watching the impact it has with interest* ***p86***

Combining innovative asset allocation with risk transfer techniques

Net Cumulative Return of the MLIS Merrill Lynch Dynamic Capital Protection UCITS Fund since inception



Controlling portfolio drawdowns and tail risks have become major discussion points in the investment community. Keen to avoid a repeat of the losses experienced in 2008, many investors are showing renewed interest in dynamic risk control strategies. Since the late 1980's traditional portfolio insurance strategies have been one major tool in the box to achieve risk control and drawdown protection. However, the last financial crisis was probably the most painful in a series of reminders that those strategies can result in low investment returns or even cash-lock with no chance of recovery above the protected level.

Drawing upon on state-of-the-art research, Koris International (Koris) has been on the forefront of translating innovative risk control concepts into transparent and rigorous asset allocation solutions that aim to address the drawbacks of traditional systematic loss control strategies. One such solution is the Dynamic Core-Satellite (DCS) strategy, which aims at maximising the participation in the upside of performance assets (eg equity) while cutting the fat tails on the left end of the return distribution. The DCS strategy allocation process is based on an available risk budget, i.e. the amount of capital available in excess of the amount to be protected and a time-varying multiplier. The protected amount is set in accordance with client requirements while the time-varying multiplier is reflective of the expected shortfall (C-VaR) inherent in the portfolio and, as the name suggests, varies with time. The multiplier further takes into account the signals from a set of proprietary market stress indicators. Koris has implemented the DCS technology for a number of advisory mandates since 2004 with encouraging results: DCS has consistently delivered the risk return characteristics agreed with investors.

Koris has partnered with the Bank of America Merrill Lynch UCITS platform, Merrill Lynch Investment Solutions to create the MLIS Merrill Lynch Dynamic Capital Protection UCITS Fund (Fund), a DCS solution specifically targeted at European insurance companies and wrapped in a Luxembourg UCITS fund managed by Merrill Lynch International with daily NAV and liquidity. Apart from cash (reserve asset) and investment grade debt, the Fund also provides dynamic exposure to higher yielding securities: high-yield, emerging market fixed income and equity (S&P 500 and MSCI EM indices) – asset classes with the common feature that they exhibit high Solvency Capital Requirements (SCR) as direct investments under the upcoming Solvency II regime. The DCS strategy employed by the Fund aims to ensure that the NAV does not fall below 86.5% of the highest NAV reached over a rolling one year period. An embedded gap swap transaction provides a formal risk transfer overlay in the event that DCS should fail to meet its loss control objective.

Although the Fund was originally designed with European insurance companies in mind, a number of pension schemes have also expressed interest in the concept. With its transparent, index-based investment universe, target returns of 6-8 per cent and limited drawdown risk of 13.5 per cent, the Fund offers an interesting diversifier to complement traditional balanced funds such as dynamic growth funds and alternative investments. Also, such a solution may help in protecting DB plan funding ratios.

Highlights of the MLIS Merrill Lynch Dynamic Capital Protection UCITS Fund

- Aimed at preserving capital and generating attractive risk-adjusted returns
- Maximised exposure to performance assets (e.g. bonds, equities) whilst strictly limiting ex-ante any potential cumulative loss
- Transparent process consisting in a dynamic allocation between cash on the one hand and performance assets on the other hand, based on the available risk budget and the daily estimates of the expected shortfall[1]
- Efficient risk transfer through a gap swap transaction with pricing that reflects the Fund's actual exposure to risky assets
- Delivered in a UCITS regulated fund with daily liquidity and net asset value publication

Besides the ready-to-invest Fund, BofAML and Koris offer bespoke DCS solutions in a variety of wrappers that can be tailored to the specific requirements of any pension schemes.

[1] The expected shortfall (or C-VaR) of the performance assets is estimated with a 99.9% confidence level over a 2 banking day horizon ("Expected Shortfall").

Learning from the insurers

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Summary

- Solvency II is set to launch in January 2016, regulating the risk-based capital, balance sheets, solvency assessments, senior management accountability and supervisory assessments of insurers.
- As preparations for Solvency II are underway, a risk-oriented framework is being put in place by insurers, along with modernising traditional investment strategies.
- Pension funds are likely to emulate insurers' actions, particularly in regards to removing unnecessary liquidity.
- Pension funds will be able to learn from the implementation of Solvency II for insurers to prepare for the possibility of Solvency II for pensions.

Solvency II, a wide-reaching review designed to straighten out the insurance industry, has been a long time coming. The live date for Solvency II has shifted several times, and has now been set at 1 January 2016, by which time European insurers will need to be prepared for the changes the regulations bring.

Framework

Solvency II has been brought about by the European Insurance and Occupational Pensions Authority (EIOPA). Its scope covers risk-based capital, balance sheets, solvency assessments, senior management accountability and supervisory assessment.

As EIOPA executive director Carlos Montalvo Rebuelta says, in a blog post on the regulator's website: "The Solvency II regime requires insurers and reinsurers to have in place an effective risk management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, both at individual and aggregated levels, they are or could be exposed, and their interdependencies."

And as Lloyd's succinctly puts it: "Solvency II is an EU legislative programme to be implemented in all 27 member states, including the UK. It introduces a new, harmonised EU-wide insurance regulatory regime. The legislation replaces 13 existing EU insurance directives."

Influence

While Solvency II is primarily an insurance issue, it is of significant relevance to the pensions industry too, as its influence takes hold and changes are becoming increasingly apparent in the way in which investment decisions are made.

"For the pensions market, it's not directly a question of solvency," explains Bank of America Merrill Lynch (BofAML) head of Ucits fund distribution Paul Holmes. "But the impact of solvency within the insurance market certainly has relevance to the way other investors are thinking about transparency, risk management and funding in a much broader sense. We have seen a huge pick-up in interest; but also in the implementation of these investment solutions, not just from the insurance community, but also the pensions world."

What's more, the way Solvency II plays out could prove a valuable roadmap for the way in which potential changes to pension regulations progress. According to BlackRock head of financial institution group Patrick Liedkte, Solvency II has impact on more areas of the market as it shifts demand."

Implementation

Indeed, even though the Solvency II changes have been brewing for the insurance industry for some years now, the fact that they are now due to become live in just over a year has been shaking up processes and focusing minds. "We are now at the practical implementation level, even though we are some way off the live date," says Holmes. "Those more practical considerations are now coming to the fore."

And Liedkte agrees: "People are realising that it is a matter of months to the big start date and they need to be getting ready, and that means that they are making sure, firstly, that they comply with the regulation per se, meaning they need to make sure they can calculate solvency capital ratios, and secondly that they have the reporting requirements and data transparency that they need to deliver in place." The changes, says Liedkte, will be sweeping, and are already becoming apparent: "I think Solvency II has changed the landscape dramatically, by putting a risk-oriented framework front and centre," he says.

And these changes are clear to see in the asset management arena. Holmes explains: "As a product manufacturer we provide fund-based alternative investment solutions to investors seeking less directional and un-correlated sources of return compared to traditional equity and bond asset classes, as well as ways for investors to get more efficient, or more targeted, exposure to their chosen investments. For insurance companies under Solvency II that can involve an element of risk transfer or portfolio protection to lower the capital requirement; for others including pensions funds it can mean delivering exposure to these alternative strategies in a very customised way, for example providing targeted volatility exposure or portfolio insurance and capital guarantees."

While many in the insurance industry have complained at the prospect of onerous regulatory requirements, Solvency II has brought a need to bring asset allocations in line with today's requirements. "From an asset management side of things, this is a great opportunity for insurance companies to change their strategic asset allocation and make their investments more productive," Liedkte says.

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Modernisation

In effect, then, Solvency II may bring a kind of enforced modernisation that will put pressure on companies to up their game. Insurance companies can ill afford to run undiversified traditional strategies that are not taking advantage of what is out there in order to provide the returns while their competitors make all the right moves – they would quickly be punished by investors.

Particularly in a low interest rate environment, and with equities nearing all-time highs, investors across the board must to look for means of achieving required returns with the necessary level of transparency. For Holmes, one of the most significant changes in recent times is the appetite for alternative investments such as the onshore structures Ucits. "We have an offering of alternative investment strategies managed by third party hedge fund managers that we deliver to investors in an on-shore Ucits structure," Holmes explains. "Ucits were originally created for a retail audience across Europe, but recently we have seen much greater appetite and interest from institutional clients, including pension funds."

According to Holmes, Solvency II has played a part in this shift in interest for a number of reasons – reasons that vary from country to country. "Institutional demand for alternative Ucits is in certain countries driven by the regulatory environment, in others due to simplified tax situations, and in yet others the transparency and liquidity that Ucits can provide." And clearly the question of transparency is not specific to the world of insurance. Indeed, arguably the changing attitudes towards asset allocation are just as relevant to pensions.

Asset classes that were once niche are becoming more mainstream for institutional investors, with the likes of infrastructure debt coming to the fore in portfolios in place of, for example, more liquid assets such as utilities. "Insurers have found out that they have a lot of liquidity that they don't need, and that they can be smarter about using that liquidity. They can transfer liquidity into the market by investing in illiquid asset classes and they get high returns," says Liedtke. "Pension

funds are looking at what traditional insurance funds are doing and trying to emulate that."

Solvency II for pensions

And there are other reasons for taking an interest in Solvency II. The spectre of a similar style of regulatory framework for pensions has been raised in the past, and, argues Liedtke, it may yet become a reality. "The pension world would be wise to look at what Solvency II is doing in the insurance world, because their future will be influenced by the same thinking. And the fact that insurers have gone ahead with this provides almost a laboratory for pension investors to get a better understanding as to what one can do and how to do it, and how the general macro trends and regulation are moving."

The importance of risk-based capital systems that are more finely tuned to the risks that companies take, and the way in which those risks are managed, is becoming clear for pensions as for other institutional investors. And fortunately for the pensions industry, it will have a clear view of how regulatory pressures in this direction pan out, and will be able to benefit from the expertise of professionals who have been through a similar process before.

Written by Sandra Haurant, a freelance journalist

In association with Koris International