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Solvency II still on the backburner

Phil Davis, Financial Times

Many of the regulatory measures conceived in the wake of the financial crisis have been delayed amid intense lobbying and difficulties in implementing complex reforms.
The haste with which they were put together has resulted in some poor constructs and few have yet been adopted.

But some financial market reforms planned well before 2008 have hit the buffers too. Solvency II, for one, was ratified by European Union legislators back in 2009 but its implementation has been repeatedly postponed. The potential impact on insurers and fund managers is so profound that few will be able to meet requirements on managing data, risk governance and regulatory reporting with the result that the January 2013 deadline has now been pushed back to early 2014. There are even doubts over this deadline.

A big issue is that insurers have to focus on exactly what their asset management divisions are doing. They also need to know exactly how third-party managers are managing their assets. They then have to feed huge amounts of information about these investment processes into untested regulatory-compliant systems so that rule-makers can assess how much risk they are taking and whether they pose a risk to the financial system as a whole.

When the directive finally comes into force, the net result will be that both captive managers and third-party funds serving insurers will have to dial down the risk they take. The result: a shift from equities to bonds, which leads to a lower cost of regulatory capital under Solvency II. To some extent this shift has already occurred organically as insurers and other investors have moved to damp volatility in their portfolios and match liabilities more closely. "Many insurance companies have already made a shift from equities to bonds so the move may not be as big as people expect," says Maxime Gibault, head of insurance business at BNP Paribas Securities Services.

The move to reduce risk is likely to have a more dramatic effect on the hedge fund industry, particularly on hedge funds with illiquid assets that carry high regulatory charges under Solvency II. Some strategies are impacted more than others. For instance, before the financial crisis hit, hedge funds were inundated with cash from investors and many decided to become part

of the so-called shadow banking system, lending money to companies that could not access traditional financing. As the credit crisis deepened some of these companies could not repay the loans, which were often converted to preference shares or equity. Hedge funds and their investors suddenly found themselves the owners of billions of dollars of unlisted private capital – as much as $70bn of investors' money is still tied up in illiquid hedge funds, according to Credit Suisse.

Unable to redeem from hedge funds because of the illiquidity, banks (wary of capital charges under Basel III) and insurers are now starting to trade in the secondary market, selling their hedge fund stakes at deep discounts. "The secondary hedge fund market is in a second wave now," says Florian de Sigy managing partner of Gamma Finance, a broker and adviser in the secondary hedge fund markets. "The first big wave of selling was by high net worth individuals, but the current wave is being driven by institutions under pressure from auditors and regulators." The result is likely to be a flow of hedge fund assets from banks and insurers to long-term investors with few regulatory constraints and redemption pressures, such as sovereign wealth funds, wealthy individuals and pension funds (to the extent they escape the Solvency II net).

The other big impact on asset managers of Solvency II is on data management. "There must be a close focus on the accuracy and granularity of assets to ensure that undue capital penalties are not incurred," says Mr Gibault. To avoid such penalties, managers need look-through mechanisms to underlying investments and a depth of analytical reporting that few currently perform. For some over-the-counter or structured products this could involve reporting up to 125 data attribution points for each line of investment.

The resources to perform this level of reporting are lacking at many insurers, but it could be nigh impossible for smaller independent fund managers to respond to the needs of their insurance clients. The cost of updating infrastructure to the standards demanded by Solvency II could force some of them to drop some of their more esoteric strategies or refuse insurance company money.

Given the complexities it is little wonder that so many firms have begged for the directive's deadline to be pushed back. There are also compelling macroeconomic reasons for wanting to delay implementation. "Insurance companies are frankly happy there has been a delay," says Faisal Khan, director of banking and insurance at 3i Infotech, a financial services IT provider. "They have their hands full of issues at the moment, not least of which is survival in the current economic climate."

A number of recent surveys, including one by BNP Paribas, indicate that planning for Solvency II is patchy. Few insurers or asset managers will be rushing to comply right now. "At the moment Solvency II doesn't appear a huge issue because the deadline keeps slipping, but six months before a hard deadline there will be quite a panic to change and test systems," says Mr Khan.