# Getting your investments in order: what should AFH's consider?

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## AFH duties

- Current – SUP 4.3.13 (paraphrased):
  - Advise the management on the capital needed to support the business
  - Monitor those risks that the insurer is exposed to with respect to meeting liabilities and holding enough capital, and inform the management if there are any material concerns
    - Need to be aware of the investment risks
- Solvency II – Article 48:
  - *"Coordinate calculation of technical provisions"*
  - *"Contribute to the effective implementation of the risk-management system…in particular with respect to the risk modelling underlying the calculation of the capital requirements"*
    - Investment governance is a key part of risk management
    - Capital role is unclear – need to "contribute"

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## Agenda

- Investment governance
- Matching Adjustment and Volatility Adjustment
- Investment issues under Solvency II capital calculations

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## Features of a strong governance framework

| | |
|---|---|
| Clear risk appetite | Clear responsibility and approval process |
| Strong documentation of requirements of investment managers | MI to enable efficient monitoring and action when required |



## Questions that need to be answered satisfactorily

- Are your risk appetite and IMA consistent (and PPFM)?
- Is approval process quick enough?
- Is Board oversight maintained?
- Does IMA reflect wishes of management?
  - E.g. Outperformance targets
- Does MI provide clear indicators of performance and risk measures?

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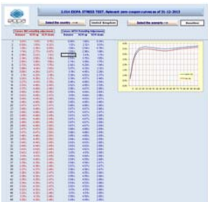
## Calculation of technical provisions

Risk free rate given by EIOPA

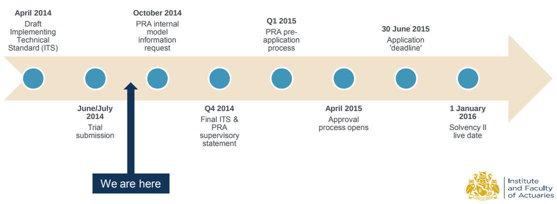
Adjustments under LTGA:

- Matching Adjustment
- Volatility Adjustment
- Transitional Measures





## Matching Adjustment – timeline



## MA application contents

| | | | |
|---|---|---|---|
| Evidence that assets and liabilities meet criteria | Line-by-line asset info (class, quality, duration, etc) | Description of how assets will be maintained if cashflows change | Evidence of adequate processes to manage A&L separately |
| Evidence that own funds have been adjusted to reflect reduced transferability | Evidence that SCR reflects reduced scope for risk diversification | "Liquidity plan" | Sensitivity analysis |
| Assess capital requirements without MA | Detailed explanation and demonstration of the calculation process used to determine the MA | Information about other applications made or expected for approval (internal models, ancillary own funds, SPVs, etc.) | |

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## MA – question marks

| | | |
|---|---|---|
| Which business? | What assets? | How much assets? |
| When can I rebalance? | How often do I have to re-apply? | How to apply in internal model SCR calculation? |

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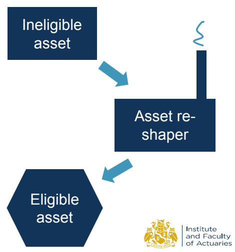
## What if can't meet criteria?

- Sell assets
- Re-allocate assets within group
- Reinsurance
  - Outside of SII jurisdiction?
  - Recoverables equal to annuity cashflows
- "Re-shape"
  - SPVs
  - Asset swaps
- Volatility adjustment
- Transitional measures

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## Volatility adjustment

- Details yet to be finalised
  - 'Reference portfolio'
  - Very difficult to hedge
- Approval process looks likely
  - HMT consultation
- PRA have six months to decide
- Fast-tracked if MA application fails?
  - Called for by ABI
  - Otherwise, have to wait (up to) another six months
- Combine with transitional measures?

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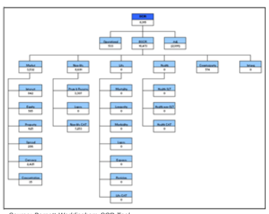
## Investment issues under SII capital calculations

- Asset data
  - Increased level of detail
- Assets to watch out for
- Treatment of hedging contracts



*Source: Barnett Waddingham SCR Tool*

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## Asset data under SII

- "Look through" approach
  - Line-by-line data
- Asset valuation
  - Reliability
  - Trading/pricing frequency
  - Mark-to-model issues
- Credit ratings
  - Appropriateness of external rating
  - Unrated can be penal

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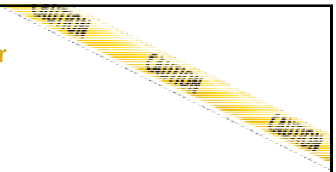
## Assets to watch out for



- "Type II" equity shock
  - Unlisted equities
  - Non-EEA/OECD equities
  - Hedge funds
  - Commodities
  - Alternatives
- Securitisations/re-securitisations
  - SCR of 100% in some cases
- Currency mismatches
  - Hedge significant positions
- Zero capital for EU sovereigns

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## Long term credit capital

### Infrastructure Debt


- Spread risk SCR for a 20y duration, BBB rated bond = 30%
- Assuming a 10% CoC and a 25% diversification benefit, cost of holding capital = 225bps
- Can see that liquidity premium is wiped out

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*Source: Deutsche AWM*

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## Hedging restrictions

- SCR may be reduced by taking into account any financial risk mitigation techniques (eg derivative strategies)
- The benefit allowed is the change in value of the derivative held under the SCR stresses
- Hedging instruments have to be eligible for standard formulae
  - Effective risk transfer to 3rd party
  - Not material basis risk (see box)
  - BBB minimum counterparty rating
- Can only get full benefit if maturity >1y or part of a documented rolling program
- Undertakings should not reflect knowledge of their SCR shocks

**Focus on basis risk**

- Overall principle: the protection must cover 90% of the changes in MtM of the underlying
- When an index-based protection is used on a particular allocation, the basis risk between the index and the allocation may be beyond limits given in the actual specifications. However:
  - Specifications are rather vague at this stage on two aspects: measurement period and the scenario under which the correlation needs to be measured
  - We believe correlation should be appreciated in stressed periods, during which the correlation between underlyings increases and on which stress tests are usually calibrated.
  - One way to show the efficiency of a protection is to use a methodology similar to that chosen in the CEIOPS Consultation Papers, where the SII stress test calibrations were discussed. Under this, EIOPA would calculate historical Cornish Fisher VaR.
  - Moreover, companies have to consider that protections are fungible in the insurance company portfolio, so that the basis risk may not be appreciated at the level of a particular investment, but at the balance sheet level.

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## Summary

- Ensure correct investment governance in place
- MA/VA affect technical provisions
  - MA application is significant undertaking
  - Start thinking about impact and asset issues now
- Be mindful of asset-side issues in capital calculations
  - Additional data requirements
  - Strategy may need to change, especially under standard formula

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**Questions** **Comments**

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