

AMPLE SCOPE FOR ALTERNATIVE INVESTMENTS UNDER SOLVENCY II

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Alternative investments remain attractive for insurers within Solvency II, despite the more onerous capital requirements for the asset class. Proprietary risk modeling by insurers and portfolio transparency are important stepping stones.

A key feature of the Solvency II Directive for European insurers is the differential treatment of individual asset classes in the calculation of capital requirements. For example, the standard capital requirement for alternative investments is higher than for a global large cap equities portfolio, whereas the latter prompts a bigger requirement than investment grade corporate bonds. The resulting pattern of expected returns on capital logically will have important consequences for insurers' asset allocations.

At first sight the introduction of Solvency II seems to reduce the attractiveness of alternative investments since the accompanying higher capital requirements dilute returns. That would put the attractive returns that alternatives can provide beyond the reach of insurers at a time that bond yields are at record lows. However, insurance executives considering alternative investments need not despair. Solvency II allows insurance companies to develop their internal risk models. These models can bring about lower solvency requirements than the standard ones. The return on capital would improve correspondingly. How would this work?

The current proposals stipulate that for global large cap equities enough capital should be held to withstand a 39% fall, while for 'other' equities this is 49%. Hedge funds, like private equity, are categorised as 'other' equities, irrespective of their volatility. The hedge fund industry body AIMA has argued that this percentage is high and the standard calculations are crude, because they do not take the underlying investments into account. This is exactly why insurance companies can gain a competitive advantage through development of proprietary risk-based capital models. If a model successfully demonstrates that

a particular investment bears fewer risks than Solvency II assumes, the amount of required capital may be lowered. The resulting improved return on capital should benefit both the insurance company's owners and its customers, with the latter enjoying higher policy pay-outs or lower premiums.

A few managers of alternative assets have embarked on preliminary internal modeling exercises. One manager estimated that the fall of 49% incorporated in standard stress tests for alternative assets could be relaxed to 15% for an event-driven risk arbitrage long/short fund. It could even be reduced to below 10% for a market neutral European equities portfolio thanks to the absence of net market exposure. Based on the cash flow profile of the underlying investments, another asset manager estimated that the capital requirement for private equity could be calibrated to falls of 30%. Of course the development of proprietary models involves considerable resources, but the potentially obtainable reductions in required capital should make the effort worthwhile for a considerable segment of the insurance industry.

Sufficient transparency is paramount to secure regulatory approval for internally developed models. Asset managers have an important role here and should disclose underlying investments, valuation methods and liquidity. Hedge funds that invest in liquid listed instruments such as shares should easily meet these requirements.

In conclusion, insurance companies considering alternative investments should not be deterred by Solvency II's standard approach to capital requirements. Provided portfolio transparency is sufficient and regulators sign off on proprietary models, alternatives can continue to help improve risk-adjusted investment returns for insurers.