DATA – THE KEY TO UNLOCKING SOLVENCY II

Flash for more insights on the challenges of the pricing and reference data community.
The European Union’s Solvency II Directive is frequently termed “Basel for insurers.” Under the directive, insurance companies must understand and actively consider their risk exposures to current and future investments over extended timeframes, and ensure they have sufficient capital reserves to cope with potential risks.

Solvency II is not just a European insurance industry issue, it impacts the entire global buy-side value chain. Whenever an in-scope insurer outsources part of its asset management mandates to a third party, the related investment manager is accountable for providing the portfolio data the insurance company must have to meet its regulatory obligations. In turn, asset servicing firms that support the funds and insurers, such as custodian banks and fund administrators, will be called upon to provide much of the data needed to achieve compliance. Solvency II requires a collaborative, community-wide effort, encompassing a range of skill sets, expertise and tools, if insurers are to meet their regulatory obligations.

In light of the systemic risks and risk mitigation weaknesses exposed by the financial crisis, a regulatory injunction such as Solvency II – that requires institutions to understand the solvency of their portfolios – has merits in principle. However, the practical implementation of this framework poses considerable challenges that as yet, have not been fully resolved.

To meet these obligations, affected institutions must address a number of common challenges, which include:

- Mapping risk exposure and building their own risk models
- Following the Own Risk Solvency Assessment -ORSA- obligation
- Understanding asset and liability positions, so as to maintain adequate capital and liquidity levels to offset their risk exposure
- Providing transparency into the methodologies used to make complex calculations, to demonstrate to regulators where the data comes from and how was derived
- Maintaining a master set of data, and updating it continuously

The key to compliance, therefore lies in timely, accurate and transparent pricing and reference data. Entity reference data supports the cross-asset roll up of investments and transactions with trading counterparties, clients, industrial sectors, asset classes and countries of risk. It is essential in enabling firms to link securities with their issuers, and thereby report trading exposures, assess capital requirements and ensure portfolio compliance. Given the regulatory burdens firms now face, the need for rapid and frequent reporting, it is vital organizations can source and leverage the requisite data efficiently.

The European Union’s Solvency II Directive is frequently termed “Basel for insurers.” Under the directive, insurance companies must understand and actively consider their risk exposures to current and future investments over extended timeframes, and ensure they have sufficient capital reserves to cope with potential risks.

Solvency II is not just a European insurance industry issue, it impacts the entire global buy-side value chain. Whenever an in-scope insurer outsources part of its asset management mandates to a third party, the related investment manager is accountable for providing the portfolio data the insurance company must have to meet its regulatory obligations. In turn, asset servicing firms that support the funds and insurers, such as custodian banks and fund administrators, will be called upon to provide much of the data needed to achieve compliance. Solvency II requires a collaborative, community-wide effort, encompassing a range of skill sets, expertise and tools, if insurers are to meet their regulatory obligations.

In light of the systemic risks and risk mitigation weaknesses exposed by the financial crisis, a regulatory injunction such as Solvency II – that requires institutions to understand the solvency of their portfolios – has merits in principle. However, the practical implementation of this framework poses considerable challenges that as yet, have not been fully resolved.

The key to compliance, therefore lies in timely, accurate and transparent pricing and reference data. Entity reference data supports the cross-asset roll up of investments and transactions with trading counterparties, clients, industrial sectors, asset classes and countries of risk. It is essential in enabling firms to link securities with their issuers, and thereby report trading exposures, assess capital requirements and ensure portfolio compliance. Given the regulatory burdens firms now face, the need for rapid and frequent reporting, it is vital organizations can source and leverage the requisite data efficiently.

**Solvency II is not just a European insurance industry issue, it impacts the entire global buy-side value chain.**

The key to compliance, therefore lies in timely, accurate and transparent pricing and reference data. Entity reference data supports the cross-asset roll up of investments and transactions with trading counterparties, clients, industrial sectors, asset classes and countries of risk. It is essential in enabling firms to link securities with their issuers, and thereby report trading exposures, assess capital requirements and ensure portfolio compliance. Given the regulatory burdens firms now face, the need for rapid and frequent reporting, it is vital organizations can source and leverage the requisite data efficiently.

**PILLAR 1**

Granular Data Requirements
Investment data at security level

**PILLAR 2**

Continuous Data Requirements
Investment data required to track investment exposure and risk

**PILLAR 3**

Comprehensive Data Requirements
Investment data reported by non standard instrument classifications

**SOLVENCY II REGULATORY REPORTING**

*SCR – Solvency Capital Requirements; MCR – Minimum Capital Requirements*
DATA ONUS
Solvency II seeks to tackle systemic risk by introducing more generous capital adequacy ratios, and modelling, leverage and liquidity requirements to ensure insurance companies have sufficient reserves to cope with financial stresses.

To be compliant, insurers must:

• Undertake market-based valuations of their assets and liabilities on a security-by-security basis
• Calculate their Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR)
• Profile their risk exposures out to a maximum of 120 years
• Access the necessary identification codes required for mapping and reporting purposes
• Obtain “look-through” data on funds and other investment structures to identify the ultimate asset and their resulting exposure
• Generate a composite rating or provide a Credit Quality Step (CQS)
• Complete the Quantitative Report Template (QRT)

Meeting this complex array of requirements presents insurers and their service providers (i.e. third-party investment managers, fund administrators and custodian banks) with a host of data challenges.

CAPITAL ADEQUACY
Insurers’ SCR and MCR calculations and risk reporting depend on accurate and regular asset and liability valuations, based on market prices for liquid instruments and evaluated prices for harder-to-value securities. Conducting internal valuations requires a range of underlying market and economic data, such as Solvency II-specific benchmark curves, rates and surfaces to aggregate, model and manage cash flows. Regulators also want full transparency into the valuation methodologies, with a clear outline between the data inputs and price outputs.

In addition, various securities, issuer, sector and ratings classification data is essential for understanding the risk profile of the securities held by an insurer, and the issuers concerned. This includes:

• Complementary Identification Codes (CICs) for instruments – the CIC is a four position code used to classify assets for Pillar 3 reporting. The first two positions classify the asset by country of listing, the third categorizes the assets into instrument type, and the fourth denotes the sub-category or main risk.
• Legal Entity Identifiers (LEIs) for counterparties – LEIs are a 20-digit, alpha-numeric code being designed to provide clear, consistent and unique identification of global financial market participants.
• Nomenclature statistique des Activités économiques dans la Communauté Européenne (NACE) for business sector of the legal entity – NACE is a four-digit classification used in the European Union to designate areas of economic activity.

FUND HOLDING EXPOSURES
Insurers could face a higher SCR unless they have an accurate view of their investment holdings. To determine their related levels of risk exposure, firms need access to detailed “look-through” data to identify and classify the content of their fund holdings by security and issuer, and then aggregate the data across holdings.

Sourcing timely and accurate constituent data across multiple fund portfolios is a burdensome task. The fund holdings content also needs to be enriched with additional security-level information, such as CICs and other industry classifications, if firms are to aggregate their fund and non-fund holding risk exposures correctly.

REPORT COMPLETION
Sourcing and mapping the correct data to populate the QRT, and providing an audit trail of that data, involves enormous effort. The data needed spans a multitude of categories, including instrument, issuer, classification (e.g. issuer sector), geography, ratings, risk and fair value price. The information then needs to be formatted consistently and mapped to the QRT, with transparency into the data’s source.

Furthermore the templates are complex, and it is difficult to understand the granular data requirements and then map the correct data to the appropriate field for disclosure. The risk of errors or omissions is high, which will likely result in regulators demanding additional ad hoc reporting, or even supplementary capital requirements if a firm’s disclosures are deemed unsatisfactory, so the importance of getting this right can’t be overstated.

CREDIT QUALITY STEPS (CQS)
To provide transparency into the credit risk associated with investments, insurers must include a CQS number in their Solvency II regulatory reports. The CQS is based on ratings from the three major agencies (Moody’s, Fitch and S&P), with the second-best value used for the SCR calculation and reporting.

Sourcing ratings from all three agencies involves substantial cost, with end-user firms having to acquire the appropriate license from each agency for the calculation to be performed. For smaller institutions in particular this will be prohibitively expensive. In addition, running the CQS analytics takes IT and data management overhead, expertise and capacity.

A COLLABORATIVE COMPLIANCE CHAIN
Increasingly, insurance companies are outsourcing investment management functions to external asset managers. This may be in the form of a single mandate, where one asset manager is charged with managing the insurer’s funds. Alternatively, the insurer may adopt a multi-mandate approach, using several asset managers based on their expertise in particular asset classes or geographic markets. In turn, the asset managers may leverage third-party fund administrators and custodians to provide vital support services, such as the daily NAV calculation where applicable.

Responsibility for complying with Solvency II ultimately lies with the insurance companies. Nevertheless, the compliance process demands a collaborative approach, with an at times extended chain of communication, in which insurers obtain and aggregate vital information from multiple sources to compile the necessary regulatory reports. Given the complexity and effort involved, this could be an opportunity for custodians in particular to offer services to help their buy-side clients.
DATA SOLUTIONS
Whatever the service support chain looks like – whether it is a Tier 1 insurer handling all the investment management and ancillary services in-house, or a smaller firm outsourcing some or all of these functions – the actual dataset required to achieve compliance will be the same. So what are the core data elements needed to meet your Solvency II responsibilities?

To power the capital adequacy calculations, risk mitigation, and disclosure tools and workflows demanded by the directive, market practitioners need access to a comprehensive range of pricing and reference data capabilities:

I. VALUATION SERVICES – Providing robust pricing and valuation capabilities for any asset in an investment portfolio. Transparency is essential, with a predefined list of attributes for equities, fixed income, derivatives and structured products, and the ability to explain to the regulator how the price was constructed.

II. CLASSIFICATIONS AND IDENTIFIERS – Complete coverage of the CIC, LEI and NACE datasets, along with global ratings data to formulate the CQS.

III. FUND LOOK THROUGHS – Insurance companies need full details of their holdings within each fund, in order to aggregate their exposure to assets held both directly and indirectly by those funds, and thereby optimize their capital requirements.

IV. BENCHMARK CURVES – Solvency II-specific benchmark curves are needed to perform more accurate risk calculations, better manage capital adequacy requirements through accurate valuations, and assist in meeting the QRT reporting challenges.

Coverage, quality and timeliness of the requisite data will be essential. This means having access to prices for the full array of liquid and illiquid securities traded on listed markets, as well as timely and transparent evaluated pricing spanning the gamut of harder-to-value securities.

Full reference data coverage is similarly vital. For example, many of the Solvency II disclosure tests depend on proper instrument classification. This classification requires 11 different data elements, including name, duration, currency, maturity date and CIC. Other key content sets include identifiers to specify each issuer (such as LEI and issuer name), issuer sector, geography, collateral posted and credit rating. And given the global nature of insurers’ portfolios, coverage across securities, issuers and markets must be both global and able to support different code standard variations for cross-referencing.

As with the rest of the regulatory initiatives being introduced, Solvency II puts a premium on data quality, in terms of the accuracy and reliability of data items, as well as the clear provenance of the information used. Asset and liability valuations – which serve as the foundation for a firms’ risk assessment and capital adequacy calculations – are under particular scrutiny. Justifiable, auditable prices, based on clear methodologies, are now a must-have. In addition, the relevant data needs to be properly formatted and mapped to the QRT template to ensure accurate and timely reporting.

Ultimately, no single provider is likely to have a complete solution to meet all the data challenges industry participants will face. Instead a collaborative approach – built on partnerships between data vendors, analytics providers, ratings agencies, asset servicers and the insurers themselves – will be essential for complying with Solvency II.

CONCLUSION
Like so much of the regulatory reform agenda sweeping different parts of the financial services industry, Solvency II demands detailed understanding and reporting of holdings, exposures, sensitivities and ownership. Timely, reliable and consistent data are fundamental to this effort.

For firms touched by the regulation, sourcing and formatting the panoply of data required to run the analysis, perform the calculations and generate the necessary reports poses significant challenges. Partnering with a trusted global data provider such as Thomson Reuters – armed with extensive data skillsets and tools, and able to leverage a network of pre-established relationships with other vital participants will be crucial to overcoming the Solvency II challenge in the most cost efficient way.

“Partnering with a trusted global data provider will be crucial to overcoming the Solvency II challenge in the most cost efficient way”
ABOUT THE AUTHOR: TIM LIND

Tim is a financial services technology executive with more than 20 years of domestic and international experience in the securities industry. His particular focus has been on the strategic deployment of technology to manage data, transaction processing and risk management. He joined Thomson Reuters in 2010, and as the Global Head of Financial Regulation Solutions he is responsible for driving continued growth in the firm's content business related to the middle office content sets including legal entity, corporate actions. Tim is also in charge of piloting the strategy to enhance Enterprise Content to support regulatory initiatives like FATCA and Solvency II.

ABOUT THOMSON REUTERS

Thomson Reuters is the world's leading source of intelligent information for businesses and professionals. We combine industry expertise with innovative technology to deliver critical information to leading decision makers in the financial and risk, legal, tax and accounting, intellectual property and science and media markets, powered by the world's most trusted news organization. With headquarters in New York and major operations in London and Eagan, Minnesota, Thomson Reuters employs approximately 60,000 people and operates in over 100 countries. Thomson Reuters shares are listed on the Toronto and New York Stock Exchanges.

SOLVENCY II

Thomson Reuters provides the industry with the leading range of Solvency II and ORSA services; offering a specialist set of Pricing and Reference Data Feeds, Tax and Accounting Consultancy Services and Risk Models. Our feeds alone provide the market with a complete set of Fund Look-Through, Ratings (Credit Quality Steps), Benchmarks & Curves in addition to vital Valuations content.

If you would like to speak to one of our many regulatory data specialists simply click here or visit www.prdcommunity.com for more information or assistance.

To view our related though leadership video on the practical requirements to undertake to comply with Solvency II, but also Shareholding Reporting obligations, simply click here.

Flash for more insights on the challenges of the pricing and reference data community.

Visit prdcommunity.com

Send us a sales enquiry at: prdcommunity.com/contactus

Read more about our products at: prdcommunity.com/index.php/solutions

Find out how to contact your local office: financial.thomsonreuters.com/locations

Access customer service at: financial.thomsonreuters.com/customers

© 2014 Thomson Reuters. All rights reserved. 1007253/6-14