Pros and cons for the upcoming new Solvency II

The problem of pro-cyclicality has been addressed but the Authorities' intervention will become even more extreme

by Alexander Ineichen*

The company

Ineichen Research and Management ("IR&M") is a research boutique focusing on investment themes related to absolute returns and risk management. IR&M was founded by Alexander Ineichen in October 2009, has an institutional investors' orientation, and is domiciled in Zug, Switzerland. The mission of IR&M is to improve the investment decisions of investors who talk to IR&M relative to those who don't. The investment philosophy of IR&M is based on the idea that it is active risk management that is the key to "absolute returns" (i.e. long-term positive compounding of capital) and is therefore the key discipline in investment management.

Regulation is increasing nearly everywhere. The Authorities attempt to improve the financial system by making it less prone to accidents and failure is laudable. However, the attempt to eliminate failure entirely is not. Failure is an elementary part of learning and therefore progress. Many frogs fell flat on their nose and many died before the frog's strong legs evolved and allowed it to jump about as they do today.

This trial and error, i.e. the process of natural selection worked very well for the system "frog" even if it did not work out for every single frog and frog-predecessor that ever lived. The same is of course true for the system "financial markets." Single market participants, certain ideas, and certain products need to be able to fail. It is part of trial and error, or evolution, or the "learning by doing" dictum. (Risk capital is called risk capital for a reason, and the term risk-free-rate-of-return is arguably the mother of all oxymorons in finance.) Without failure, progress does not happen. "Success is going from failure to failure without a loss of enthusiasm," as Winston Churchill put it.

When the "learning by doing" process is disturbed, capital is misallocated as a result. One reason for this process being disturbed is the interconnectedness of financial institutions. Some are literally too big to fail. The societal costs of failure are too high; or are perceived as too high by those in power and their masters. But abandoning single entity failure through governmental intervention not only rewards failure but also disturbs the systems' ability to improve and progress and to allocate capital smoothly and efficiently. It is a perverted form of Robin Hood's code (of stealing from the rich and giving it to the poor); essentially giving to the profligate, reckless and failed by taking from the frugal, diligent and successful. By artificially trying to eliminate small failures, the system is weakened and the system's complete failure becomes inevitable. Something that cannot go on forever will not. Herbert Stein's Law applies.

Applying financial orthodoxy is dangerous for system and investors alike. Accidents lurk in all man-made systems.

There is uncertainty. Markets can erase investors' wealth overnight (for example when socialists/communists land a successful coup), asset classes can compound negatively for decades, sovereigns can default on their obligations, monetary Authorities can inflate ones' wealth away (together with someone else's debt), currency unions can fail, etc. I believe it is uncertainty that is the proper way to think about risk and the management thereof. However, this is not at all in the mindset of the bureaucrats and scholarly technocrats drafting legislation and regulation of our financial institutions. Confusing uncertainty with volatility or VaR is irresponsible and dangerous.

The main idea of Solvency II is for European insurers to move from a risk-insensitive to a risk-sensitive reporting based on market values. Solvency II will introduce economic risk-based solvency requirements across all EU member states.

These new solvency requirements are anticipated to be more risk-sensitive and more sophisticated (read: more complex) than current local requirements. These requirements are intended to provide better coverage of the real risks run by any particular insurer. Solvency II adopts a three-pillar approach akin to Basel II and is expected to be implemented by January 2013.

Punitive capital requirement for alternative investments

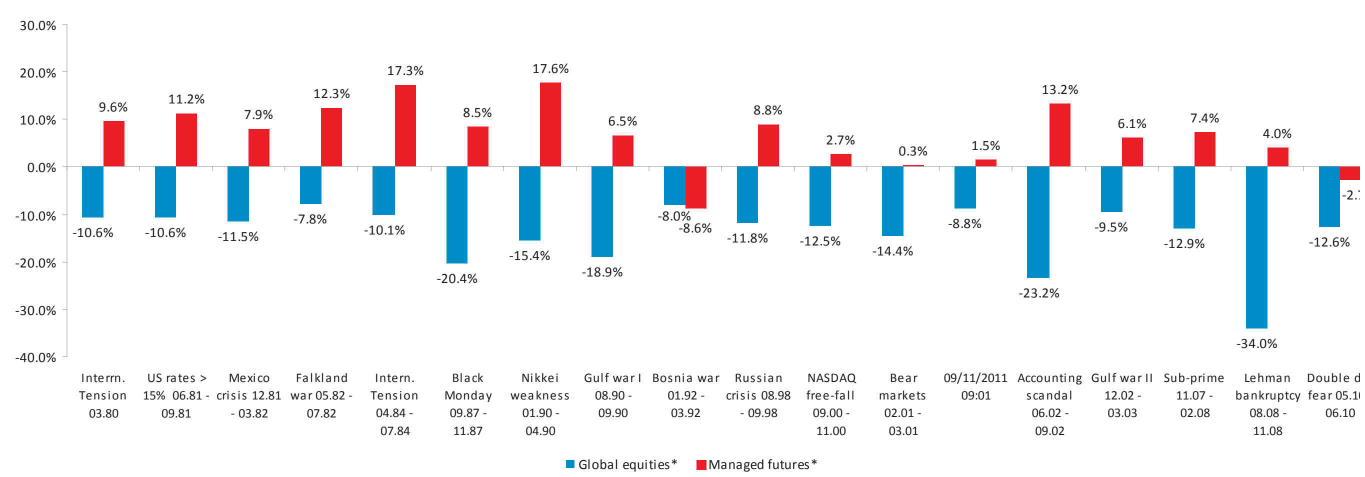
The introduction of risk-sensitive regulation can result in de-risking. This bears the risk of de-risking the wrong risks. Solvency II provides two different approaches to stress test an insurer's equity stake. In the first approach, equity is divided into "global equity", i.e. listed equities in OECD and EEA countries, and "other equity". Hedge funds, as well as equities listed in countries other than EEA and OECD countries, non-listed and listed private equity, commodities, infrastructure, and other alternative investments are classified as "other equity." The basic capital charge for "other equity" was determined at 49%. This means that a European insurer needs to hold 49 cents of capital for every Euro invested in "other equity." The correlation between "global equity" and "other equity" is set at 0.75. This obviously ignores the extreme observation of Managed futures having a negative correlation with equities when equities fall.

Managed futures compound positively when equities compound negatively. Chart 1 compares Managed futures with global equities and the graph speaks more or less for itself.
The graph shows all occurrences where the MSCI World lost more than 7% of its value within one, two, three, or four months from 1980 to 2010 on a month-end basis. The negative equities event was then compared to a proxy for Managed futures over the same period. The correlation is negative when investors need the negative correlation.
The negative correlation properties seem to work roughly 16 out of 18 times. Managed futures is the only investment I can think of that has negative correlation to equities when they fall and has a positive expected return. And it is investments such as the one in Chart 1 that are treated punitively compared to for example government bonds from, say, Greece.

Market impact

A critical part of micro-prudential regulation in the last decade was the increasing use of market prices in valuation and risk measurement. This was done in the name of transparency,

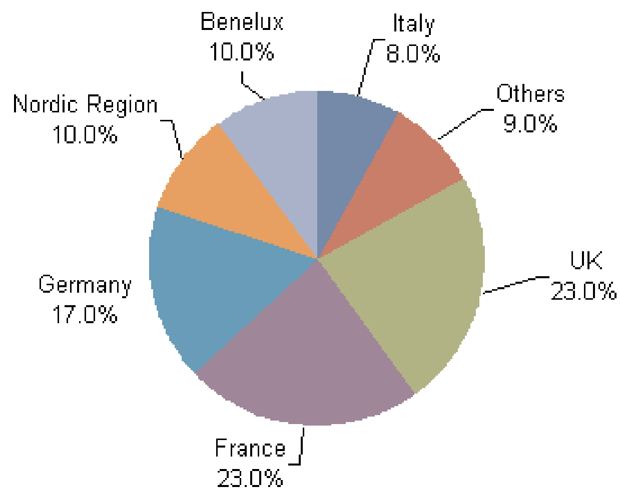
Managed futures in difficult market environments (1980 – 2010)



*Source: Ineichen Research & Management, Bloomberg * MSCI Daily TR Gross World USD Index;*
*** CISDM CTA Asset Weighted Index formerly known as CISDM Trading Advisor Qualified Universe Index*

Chart 1

European insurance companies' market share



Source: Cea

Chart 2

risk-sensitivity and prudence, but what it achieved was increasing homogeneity of market behaviour and as a result increased systemic fragility. Market based measures of risk end up being highly pro-cyclical, falling in the build-up to booms and rising in the subsequent crashes.

There is little doubt that regulation makes the financial system more homogeneous. It is market heterogeneity that is healthy from a systemic risk point of view, not homogenisation and normalisation through governmental intervention.

Regulation makes lemmings out of otherwise intelligent people. The impact of regulatory change, in this case Solvency II, is synchronised behaviour of economic agents and a system that is, due to homogenisation, more prone to accidents. In 2002, for example, both UK and Swiss insurers were more or less forced sellers of equities due to solvency-related issues. Solvency rules caused life insurers to dump GBP 30 billion worth of equities (at the time the allocation to equities was around 70% of the portfolio) in the UK at roughly the same time during 2002 (close to market lows) as the Swiss insurers were selling equities in anticipation of SST (Swiss Solvency Test).

The take-away from this episode is that solvency-related mass de-risking occurs at market bottoms, and not at market tops or during a normal market environment. History could very well repeat itself in that regard. While predictable and anticipatable market behaviour might offer an investment opportunity for the savvy investor, it is unlikely that it was the legislators intention to hand out presents to hedge funds. Note that the problem of pro-cyclicality has been recognised.

The capital charge will be adjusted periodically in a symmetrical fashion, i.e. plus or minus 10% of the basic capital charge. The most recent adjustment factor we came across was -9%, which would result in a capital charge of 40% instead of 49%. This adjustment was designed to take into account the pro-cyclical behaviour in mainly falling markets. The positive spin on this recognition is that one of the problems of regulation and market homogenisation has been addressed. The negative spin of this adjustment is that the Authorities' intervention and involvement in micro-managing the investment portfolios of institutional investors will become even more extreme.Under Solvency II the Authorities influence/intervene in both strategic as well as tactical asset allocation decisions of European insurers. Karl Marx must be smiling from wherever it is failed economists go when they die. ■

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