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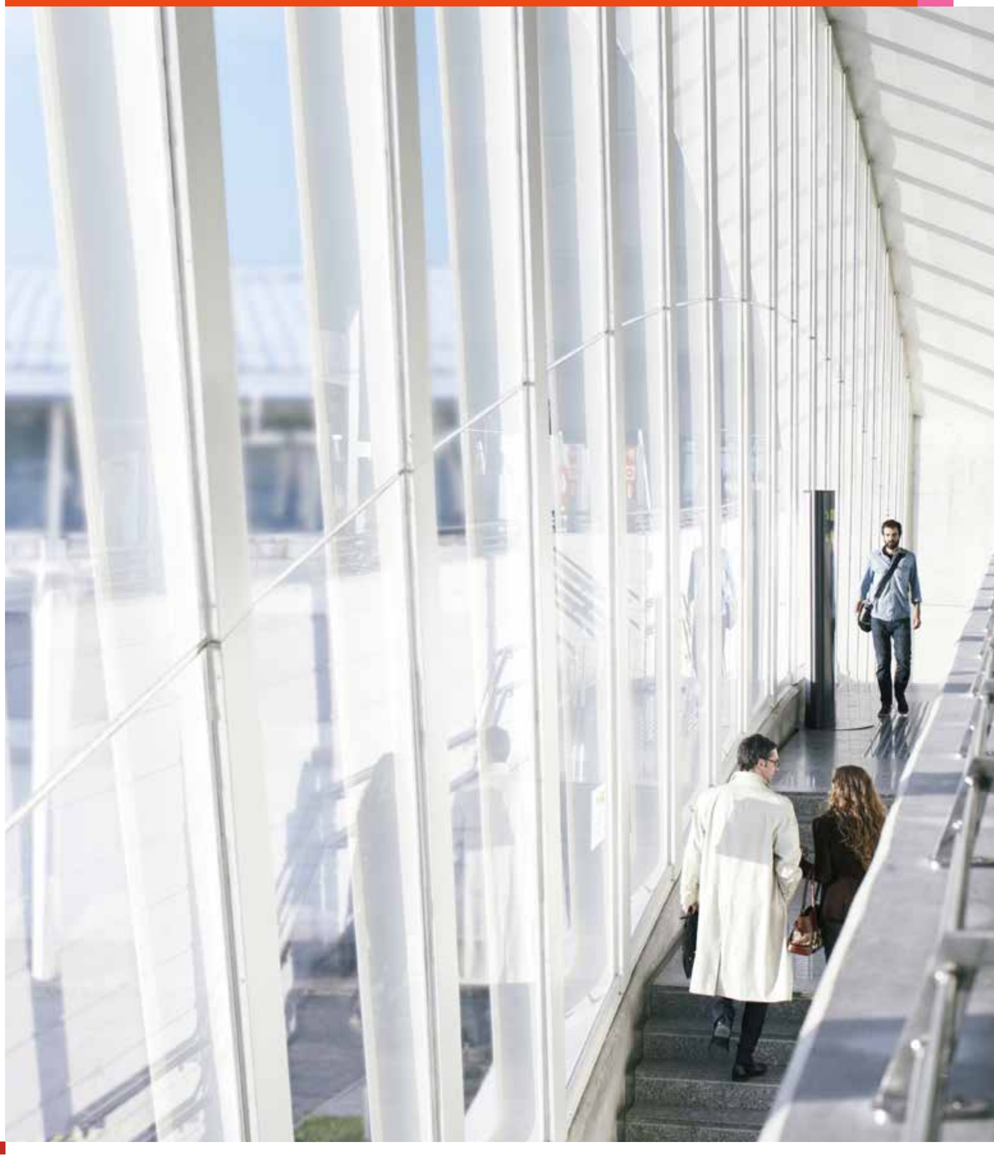
Solvency II for asset managers
Putting you in control

Enhancing your controls to meet your clients' needs



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Why should asset managers care about Solvency II?

As Asset Managers, you are facing significant regulatory change in your own industry, with FATCA, AIFMD, UCITS IV and Dodd-Frank all making their mark. So you may be tempted to dismiss Solvency II as a piece of regulation that is relevant only to the insurance industry, and put it near the bottom of your ever-expanding to-do list. This would be a mistake. For your insurance clients (and potential clients), Solvency II is the biggest regulatory change in a generation – and the impact on them will be clearly felt by you as well.

At a minimum, your insurance clients will expect you to be able to support their need for data, as Solvency II increases the volume, granularity and frequency of reporting. Insurance clients will also look to gain comfort that the data you provide them with is complete, accurate and appropriate. Ambitious asset managers may go further – seeking to become the investment partner of choice for insurers through added-value calculation and reporting services, and through designing investment products with insurers' capital calculations in mind.

The need for internal controls

This article focuses on the need for internal controls – the processes that you have in place to comply with your clients' requirements, including their need for complete, accurate and timely reporting.

For many years, asset managers have been expected to maintain a well-developed system of internal controls that satisfies the needs of their institutional clients. The implementation of Solvency II will quickly increase your insurance clients' demands with regard to your internal controls, leaving you with two challenges: how to expand the range of your internal controls, and how to report this to your clients.

What is driving the requirement for additional controls?

Where insurers have outsourced functions to a third party, Solvency II will require them to have a written outsourcing contract – in the case of asset management, typically an Investment Management Agreement (IMA). This must include:

- a right for the insurer, its supervisor (regulator) and its external auditor to have effective access to all information relating to the outsourced functions (including the ability to carry out on-site inspections at the service provider)
- a right for the supervisor to ask direct questions to the service provider
- a right for the insurer to obtain information about, and issue instructions concerning, the outsourced activities[1]

Furthermore, on an ongoing basis, the insurer needs to:

- Ensure that the service provider's risk management and internal control systems are sufficient to ensure the insurers' governance is not materially impaired and that operational risk is not unduly increased
- Ensure that outsourced activities are taken account of in the insurers' risk management and internal control system[2]

The 'insurers' risk management and internal control system' clearly includes those controls relevant to the management and reporting of risk under Solvency II.

Your institutional clients already have significant financial reporting obligations and because of this, expect you to provide a high level of disclosure over controls that are relevant to their financial reporting. This is typically achieved through operational due diligence inquiries from your client, visits from their internal and external auditors, or the provision by you of an independently tested report on controls under an internationally recognised framework such as ISAE 3402[3] or SSAE 16[4].

Your clients apply high standards to controls relevant to their financial reporting and under Solvency II, they will apply those same high standards to controls over regulatory reporting.

1 Source: Article 49(1), Level2 implementing measures Article 264 SG12(1), Level2 implementing measures Article 264 SG12(4)

2 Source: Level2 implementing measures Article 264 SG12(5) - (6)

3 International Standard on Assurance Engagements (ISAE) 3402 'Assurance Reports on Controls at a Service Organization' issued by the International Auditing and Assurance Standards Board

4 Statements on Standards for Attestation Engagements 16, 'Reporting on Controls at a Service Organization', issued by the American Institute of Certified Public Accountants

So where do we start?

A good starting point is to consider the controls you already have, as many of these remain relevant to reporting to clients under Solvency II. Your existing controls should be designed to ensure the completeness, accuracy and appropriateness of information provided to institutional clients in their regular statements of holdings, transactions and performance. They should also be designed to ensure that you manage clients' accounts according to the guidelines and restrictions set out in their mandates (or in the case of funds, the offering memorandum or prospectus).

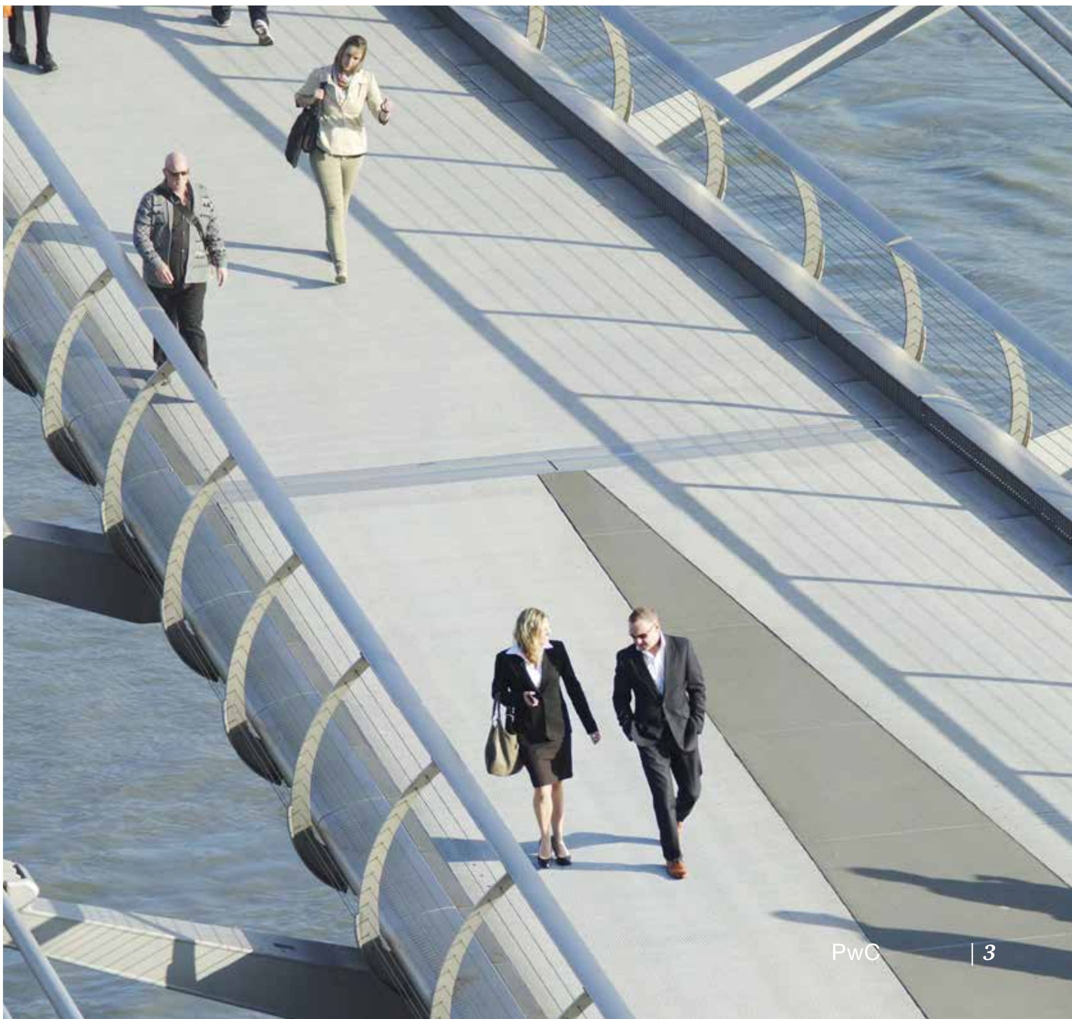
The quality of asset managers' controls varies from firm to firm. For global asset managers, a strong controls framework over compliance and the firm's own financial reporting is often enforced by regulation. Many large asset managers (especially those focused on 'traditional' long-only portfolios) also obtain independent assurance on their operational controls, covering areas such as transaction processing, investment limits and portfolio valuation. But in many cases, controls over client reporting have room for improvement.

Under Solvency II, you will need to provide an increased range of reports to your clients and expand the information provided in your existing reports. Investment restrictions and guidelines are likely to increase and become more complex.

But many of your existing controls will still be relevant, and the additional controls you require will complement rather than replace your current controls.

So before identifying the new controls required for Solvency II, it's worth taking stock of how your existing controls are defined, documented and updated. For large asset managers, or those with a strong controls culture, there may be a risk and controls 'library' maintained by senior management (or on their behalf by a function such as compliance, operational risk or internal audit).

At other asset managers, controls documentation may be limited to those controls which are independently tested by internal audit or by external auditors (for example in an ISAE 3402 report), and other controls may be documented informally – for example in locally maintained procedure manuals – or not at all. If you are not satisfied that your existing controls are formalised and monitored appropriately, Solvency II provides a strong incentive to improve this.



How can we identify which new controls are required?

The following six-step approach may help you to identify those new controls required for Solvency II:

1. Understand the relevant risks – This requires an understanding of the Solvency II regulations but perhaps more importantly, the requirements of your insurance clients resulting from Solvency II, both in how investments are managed and how asset data is reported. To use an example that we'll look at throughout this section, one risk is that the asset-level data required by Solvency II (e.g. CIC codes or credit ratings) are recorded inaccurately in your portfolio management system (or supplementary database).

2. Develop control objectives that address these risks – Related risks are grouped together and statements are set out regarding what your controls are trying to achieve. For example, a control objective that addresses the risk above is 'Asset data that are reported to clients are recorded completely and accurately'.

3. Document existing controls in these control objectives – A 'control' in this context is a process, applied in response to a specific event or at a specific frequency, which is designed to prevent or detect an error. Each control objective is likely to require a number of controls to address all its specific elements. Using the example above, a four-eyes check on any manual amendments to asset data, where a second team member checks the input of a first back to its supporting documentation, might be a strong control to prevent asset data from being recorded in the system inaccurately.

4. Conduct a gap analysis to identify weak or missing controls – Using the control objective suggested in (2), if no controls could be identified to ensure that (for example) all records of bonds were assigned a credit rating and rating issuer, this would not meet the requirement that 'Asset data [...] are recorded completely'.

5. Design and implement new controls resulting from gap analysis – Continuing the example, a control could be put in place whereby the system produces a weekly automated report showing all assets missing one or more pieces of required asset data, and this report would be reviewed weekly by an individual in the operations department with follow-up of missing items.

6. Implement a controls monitoring framework (e.g. three lines of defence) – To ensure that the control above continues to operate in practice as well as in theory, the compliance or operational risk department could perform a secondary check that operations have applied this control (for example, by reviewing operations checklists).

Alternatively, compliance could review those assets that have not been updated beyond a certain deadline. Finally, internal audit could review the effective operation of the control on a sample basis, as part of an annual review.

Will we need to modify existing controls?

If you have a well-defined set of controls over your asset management operations already, you will also wish to consider how your existing control objectives can be made applicable to Solvency II requirements. For example, you may have a control objective that aims to ensure that 'Investment limits and restrictions are established'. But your existing control activities may not cover all the limits and restrictions relevant to Solvency II – for example, limits on repackaged loans imposed directly by Solvency II, or new kinds of limits requested by your clients as a result of Solvency II (for example, around credit ratings on corporate bonds). You may also wish to reevaluate your controls around product risk, given the 'prudent person principle' endorsed by Solvency II in respect of allocation across asset classes.

You will also need to consider the impact of Solvency II on your technology controls. Systems that include automated controls, automated calculations or automated reports relevant to Solvency II data should be included in the design and monitoring of technology controls (for example access to systems, transmission of data and development of systems). This will require early engagement with your IT department.

Finally, Solvency II may result in the need to add or replace your own service providers, if your current service providers are unable to supply all the data required. If new service providers are operating controls on your behalf, you will need to consider the controls you have in place to select and monitor these providers.

Is there any help available?

In the UK, during the development of the ICAEW[5] Technical Release AAF 01/06 ('Assurance reports on internal controls of service organisations made available to third parties'), the asset management industry, along with professional services firms and representatives of institutional clients, developed an industry standard set of control objectives relevant to financial reporting.

Asset managers again have the opportunity to work together, through their industry associations and with assistance from professional services firms, to develop a standardised set of control objectives for Solvency II reporting. We have developed some examples of new control objectives and thoughts on how existing control objectives may be affected.

[5] Institute of Chartered Accountants in England and Wales

For asset managers with an existing controls report under a framework such as ISAE 3402, we believe that an extended 'edition' of this report will be the most efficient and effective way to provide comfort.

Providing your insurance clients with comfort over your controls

Developing a complete set of controls that are relevant to your insurance clients' obligations under Solvency II will help you to ensure that the reported data is complete, accurate and appropriate, and that you are managing investments in line with those clients' requirements.

However, your insurance clients are also likely to want their own assurance that your controls are sufficient for their needs. There are a number of ways they might achieve this:

- Reviewing your own internal testing – This may be the quickest option, but it would require that your internal testing is conducted by those with sufficient competence and independence, for example an internal audit department. You may also prefer not to share the results of internal audit testing with your clients – these reports are typically intended for managements' use and can contain sensitive recommendations. Also, your clients may not perceive internal audit as sufficiently independent.
- Conducting their own testing – By using due diligence/outsourcer management teams or their own internal audit department, insurance clients may achieve a high level of comfort on whether your controls achieved the right outcomes with regard to their own accounts. But there may well be difficulties around confidentiality (for example, you would not want one client reviewing controls that operated over another client's account), and visits from multiple clients would be inconvenient and disruptive to your business.
- Engaging a third party to conduct testing – This is similar to the approach above, but rather than using an in-house team, your clients would engage a professional services firm to conduct the testing. This would still result in multiple visits to you by different audit teams.
- Reviewing a controls report that covers the activities in scope – This is how many institutional clients currently get comfort over controls relevant to their financial reporting. Under this approach, you would engage a professional services firm to conduct testing and provide an independent assurance opinion on the fair presentation, suitable design and operating effectiveness of your controls, using a well recognised framework. For asset managers with an existing controls report under a framework such as ISAE 3402, we believe that an extended 'edition' of this report will be the most efficient and effective way to provide comfort.

If you adopt the controls reporting approach, you will want to work with a provider who understands the new regulations and works with you to report on an appropriate set of controls – enough to satisfy your clients, but not so many that it becomes a burden to you.

There is little doubt that Solvency II will make your insurance clients increasingly demanding with regard to your internal control framework. By starting early and consulting widely, you can ensure you have the right controls in place to serve your insurance clients' needs, and the right approach to providing them with assurance on your controls.

Along with others who provide services to the insurance industry, asset managers that have a robust control framework over Solvency II data, and that are willing to share that framework with their insurance clients in a reliable manner, are likely to have a competitive advantage in attracting and retaining institutional clients.

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