Risk Management

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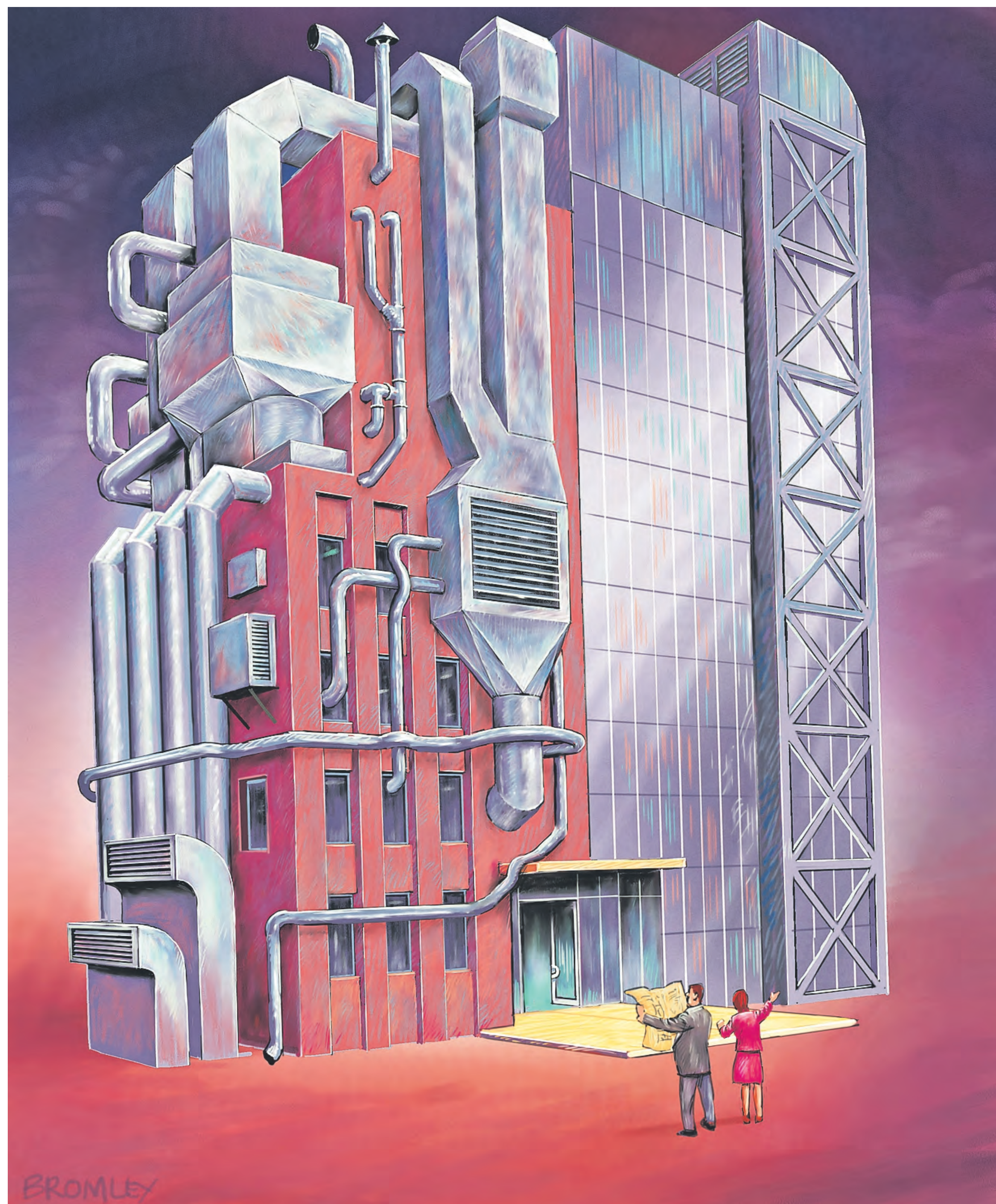
Insurance divides over shared rules

Solvency II After well over a decade in the making, EU-wide regulation is with us, writes *Oliver Ralph*



To its fans, it is a beautiful example of harmonisation, a way of protecting customers and investors that also helps to create equitable European conditions. To its opponents, it is an overly complex piece of regulation that will push up prices for consumers and impose an enormous extra administrative burden on companies.

Even after more than a decade and a half of planning, discussion and fine tuning, the EU's Solvency II insurance rules are displaying their potential to divide opinion in the industry.

The regime came into force on January 1 and is the biggest change in European insurance regulation since the 1970s. Out goes a patchwork of local systems, in comes a common set of rules across the EU.

Jeff Davies, partner at EY, sees two big differences from previous regimes. "The first is that it is a market value balance sheet, whereas for most of Europe it was a book value balance sheet before. Moving to market values will make balance sheets more volatile," he says.

The other is a move to what is known as a "risk-based approach" to capital and regulation. Insurers have to ensure that they have enough capital on their balance sheets to withstand a level of stress that is deemed likely to happen only once every 200 years. The risks to assets and liabilities are examined in a far more detailed way than before.

"Risk-based capital is a great thing," says Omar Ripon, partner at accountants Moore Stephens.

"The best firms are looking at using it to improve their returns. If you only look at it from the compliance angle, you won't get the benefits."

At a very high level, Solvency II shares some features with the equivalent in the banking world, Basel III. It is a three-way approach to supervision: the first is the calculation of capital levels; the second is internal control and supervision by regulators; and the third is supervision by the market, with added reporting requirements so that outsiders can come to their own conclusions.

As with Basel III, there are transitional rules to help companies adapt to the regime. So January 1 was for many insurers part of an evolution from what they used before, rather than a revolution. As with the banks, insurers can use either internally developed models or standardised models produced by regulators to work out their capital requirements.

That is where the similarities end. The long process required to create the new system shows how complex it was to create a common set of rules to cover national insurance markets that had evolved in very different ways.

"There was a lot of lobbying and campaigning," says Mr Davies. "Everyone had their own pieces that they wanted and they had to be traded off against each other."

David Prowse, senior director at Fitch Ratings, notes that work remains to be done on harmonisation. "Different countries have different opt-outs via transitional arrangements. And there are differences in terms of how each regulator interprets the rules."

For now, the main focus for analysts and investors is the Solvency Capital Ratio or SCR. This is a measurement of the amount of capital that insurers have available as a proportion of the minimum required. The higher the ratio, the more spare funds the insurer has.

Regulators and insurers have been at pains to stress that the ratios are not comparable with those that were used before or with those reported by other insurers because of the different ways that the rules have been interpreted.

Nevertheless, early indications

Continued on page 3

Inside

Unfinished business of reforming insurers
Head of EU's insurance supervisor discusses next steps in regulation
Page 2

Comment
Why politicians have embraced behavioural enforcement
Page 2

Spain's banks diversify
Santander and BBVA insulate themselves with global expansion
Page 2

Solvency II timeline
The pan-European regulation has faced several setbacks and delays over the years
Page 3

Perils of star manager defections
Fund companies learn retention lessons the hard way
Page 4

Danger from within: the threat staff pose
Finance companies are investing in compliance training to address people risk
Page 4

Spectre of 'Basel IV' looms into view for battle-worn lenders

Banking

The industry has yet to adjust to framework of Basel III, reports *Laura Noonan*

If you want to see a grown banker cry, the phrase "Basel IV" should do it.

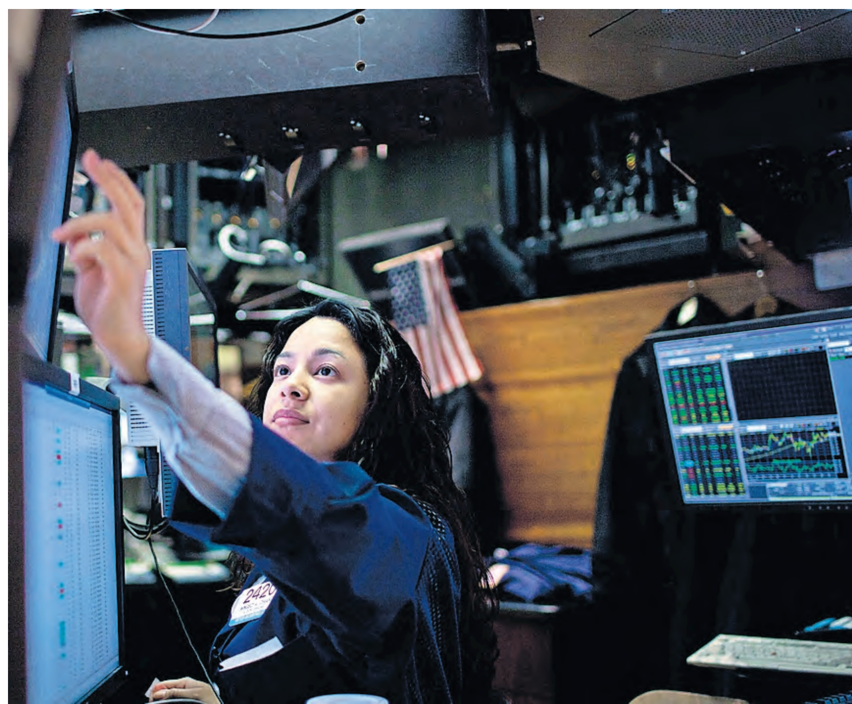
Banks have spent the past few years raising hundreds of billions of dollars of capital, hiring tens of thousands of regulatory staff, shedding trillions of dollars of assets and getting rid of their riskier businesses in order to meet Basel III capital rules. This framework was designed to reduce the risk of a run on the banks.

While Basel III will not be fully in force for another three years, its successor already ranks highly on the list of things keeping global bank bosses awake at night. Basel IV — a term some bankers are giving to a group of proposed rules that will increase the capital requirements of Basel III — looms menacingly for bankers, even though some regulators deny that it exists.

"I remember [regulators] saying there was no Basel III when the whole industry was talking about Basel III," says Giles Williams, a long-serving partner in KPMG's regulatory practice. He adds that what regulators are now working on "seems to be a remarkably different package in practice to what came out in 2010" with the announcement of Basel III.

Bankers and regulatory experts expect Basel IV to have three main elements.

The first is an overhaul of the capital treatment of banks' trading books. Last November, the proposed rules threatened to increase some banks' capital requirements by as much as 800 per cent. They have been refined since then but still threaten to have a large impact on banks with big securities operations. The overall result is to make trading activities far more expensive for banks than envisaged under the Basel III proposals.



Trading down: banks have cut capital intensive activities — EPA/Justin Lane

The other two planks of Basel IV are a more pointed departure from Basel III.

Under Basel III, banks' most important capital ratios are heavily reliant on a calculation banks do themselves. The key capital ratio is banks' equity divided by their risk-weighted assets (RWA). Banks come up with the RWA number by making a judgment on how risky various loans and other assets are.

> 'Regulators are asking the right question, but ending up with the wrong answer'

The Basel Committee on Banking Supervision is considering restricting the way RWAs are calculated in two ways. First, it will analyse the way banks assess the riskiness of their loan books and is likely to reduce banks' flexibility in calculating RWAs.

Second, the Basel Committee is looking at how banks calculate operational risk, which includes things like fines, IT failures and cyber crime. Once again, the likely outcome is new constraints.

These reviews were born from regulators' despair at the wide discrepancies between the RWAs calculated by different banks. A Basel Committee study published in July 2013 showed vast differences in the results of banks' RWA assessments. While this was mainly because of the different assets the banks held, the researchers said this was partly a result of a lack of consistency among the banks over how they treated the assets.

"Regulators are asking the right question, but they're ending up with the wrong answer," says a senior executive at a large European bank, speaking off the record given that relations with regulators are sensitive.

The executive adds that there were legitimate reasons for differences in RWAs: "Having a blunt Basel IV set of standardised RWAs is actually not correct and it's dangerous."

The "danger", widely cited among bankers, is that the new set-up could make banks less sensitive to risk. If there is minimal difference between the capital required for high-risk and low-risk loans, banks might be likely to make more high-risk loans as they will typically carry higher rewards. "The solution to this is not having blunt and equally applying instruments," the executive says. "It's having a more intelligent discussion bank by bank."

Other banks argue that the Basel Committee's latest initiatives are unnecessary, given the big changes banks have made following the financial crisis.

Banks have overhauled their business models, exiting or radically cutting areas such as trading in favour of less capital intensive activities like advising clients. European banks have raised more than €400bn of equity since 2007. The biggest US banks have improved their capital ratios by more than half since the crisis. Bankers say what their industry needs is regulatory certainty and a period of stability in order for them to rebuild their shattered margins.

Some believe the EU's new financial services chief, Jonathan Hill, will be an ally in this quest as he seems to be in favour of paving the way for banks to play their role in Europe's capital markets union.

The global thirst for new regulation, though, appears unquenched. As well as the Basel IV package, the world's biggest banks have to meet new rules requiring them to have higher levels of capital that can be "bailed in" if a bank runs into trouble. Some now see such evolution as a permanent fact of life.

Systems creak under regulatory pressure

IT infrastructure

Banks and insurers often have a patchwork of old internal systems, writes *Rochelle Toplensky*

Financial services companies are under increasing regulatory pressure to revamp their reporting and internal systems. While companies have had to invest to update their creaking IT infrastructure, some executives and investors question whether the resulting disclosures will achieve their aim of boosting market oversight.

Under the new Solvency II framework, for example, insurers are required to carry out complex calculations on how diversified their businesses are in order to gauge the amount of capital they need to hold. While computers have made the modelling faster, the process is no less complicated.

Industry consolidation over the years has left many insurers with a patchwork of decades-old IT systems. "The existing systems are not capable of delivering what the regulators want," says Philippe Chambadal, chief executive of SmartStream, an IT supplier to the financial services industry.

To meet the new rules, the insurance industry has spent billions of pounds and overseen building new IT systems. José Morago, chairman of the Institute of Risk Management, estimates that British insurance companies have spent more than £2bn on the Solvency II project and that more than half was spent on IT infrastructure. "There has been a huge investment in systems," says Mr Morago, adding that a lot of people have been "involved in implementing and changing decision making".

He believes more work is needed to help senior executives understand and trust capital models so they can use the information to make effective decisions.

Companies can use their own internal models to assess their capital needs, if they are approved by national regulators. Otherwise, they are required to use regulators' standard models.

In the UK, 19 companies have had their own models approved by the Bank of England's Prudential Regulation Authority, including Prudential, Aviva and Standard Life.

Simon Woods, transaction advisory partner at EY, believes the new information required under Solvency II will help managers at insurers to understand their company's profitability better and shift their attention to increasing returns on capital rather than driving up income or revenue. This will help insurers make better decisions, he says.

Insurers have published some Solvency II information in their 2015 results ahead of formal disclosure requirements. But some believe the experience of banks preparing for the Basel III rules provides bleak signs for insurance companies, their regulators and investors over how useful the newly required disclosures will be to investors.

Like Basel III, one of the aims of Solvency II is to provide additional data to the market so that it can understand the companies and provide oversight.

But Basel III disclosure has also added to banks' heaving annual reports. While some sophisticated investors welcome the additional information, many believe it is not effective.

British insurers have spent more than £2bn on the Solvency II project, estimates José Morago of the IRM

"Sophisticated actors use [the additional disclosure], but not to the level it should be [used]," argues Vincent Papa, director at the CFA Institute, a US-based association of investment professionals.

Interview
Gabriel Bernardino

Europe's top insurance supervisor talks to *Oliver Ralph*

Insurer reform remains work in progress

Long-term plans: Bernardino will lead Eiopa for another five years Sam Kesteven

For a man who has just spent a decade involved in complex, detailed and sometimes fractious talks on insurance regulation, Gabriel Bernardino is remarkably upbeat. Mr Bernardino, chair of the European Insurance and Occupational Pensions Authority (Eiopa), the body responsible for putting the EU's Solvency II rules into practice, says it has all been worthwhile.

"It was one of the most open, transparent, debated projects in financial regulation worldwide," he says. "What we have in Solvency II is a pretty fantastic step."

Solvency II is a big change in the way insurance companies in the EU are regulated. Instead of the previous array of rules governed by each member state, Solvency II is supposed to be an EU-wide system that imposes the same standards on everyone.

Getting to that point has been a much-delayed process. The idea was first proposed in the early 2000s but the financial crisis and disagreements over details intervened. It did not come into force until the start of this year and it will be another 16 years before the rules are fully phased in. Transitional measures apply for some insurers before then.

Mr Bernardino has been at the centre of the process. He earned his regulatory spurs in his native Portugal. After graduating in maths from the university of Lisbon, he spent much of his career with the Instituto de Seguros de Portugal, the Portuguese insurance institute. He has been chair of Eiopa since its creation in 2011, when it replaced the Committee of European Insurance and Occupational Pensions Supervisors.

At its heart, Solvency II is an effort to make insurance supervision more sensitive to changes in the risks that the insurers take.

"The overall aim was to bring risk-based supervision to the EU," he says, adding that there were three areas of focus. "The first was to have better alignment of capital and risks and better valuation of assets and liabilities on a market-consistent basis. The second was to put risk management at the core of the prudential regime. The third was to significantly enhance the transparency of the regime and to increase public disclosure of the specifics of insurance."

Solvency II went live on January 1 2016. Insurers have spent hundreds of millions of pounds and euros preparing for it and are still getting used to how it works. It also has consequences for investors, financial analysts and customers.

For Mr Bernardino, the latter group is the most important. "The objective of Solvency II was to enhance the level of protection for policyholders." If assets and liabilities are more accurately matched, so the theory goes, there is less chance that customers will be disappointed when they really need their insurance policies to pay out.

The more immediate impact is on the analysts and investors who deal regularly with the insurers' financial statements.

"For investors, Solvency II increases tremendously the amount of information about insurers' business models and possible consequences of the risks they bear. When you go for a risk-based system you need an element of market discipline, so investors need to learn more about all these details," says Mr Bernardino. He admits that "moving from Solvency I to Solvency II will take some time for investors to understand the new metrics".

Investor comprehension is not the only thing that will take time. Although the rules came into force at New Year, Mr Bernardino says there is still a lot of work to be done. "We're at the end of the journey with the regulatory phase but we've now entered the implementation phase," he says. "We need to make sure we move ahead with supervisory convergence."

The biggest challenge is ensuring the rules are applied uniformly throughout the EU. Although the regime was created centrally, it is up to regulators in each member state to put them into practice, so there is plenty of scope for implementation to differ across the EU.

"We're in an internal market but we all have different perspectives on supervision. We need to make sure that there is similar protection for policyholders everywhere, a level playing field and no opportunities for regulatory arbitrage. These three elements are fundamental."

Mr Bernardino plans to keep the diverse regulators in line by issuing "supervisory opinions" whenever Eiopa sees a difference of interpretation between member states.

> 'It was one of the most transparent, debated projects in financial regulation worldwide'

The treatment of sovereign bond holdings is one area where he sees scope for improvement in the rules. At present, insurers using their own internal models to calculate their capital needs have to treat sovereign bonds in a different way from those insurers who use a standard industry model.

As well as his supervisory opinions, Mr Bernardino is looking towards long-planned reviews of the rules at various points over the next five years, as well as a series of insurance stress tests that are due to take place later this year. The tests will focus on strains to both the asset and liability sides of insurers' balance sheets.

Despite the efforts of the past decade, he is sticking around to see through any changes that are considered necessary. His first five-year term as head of Eiopa finished at the end of February and he has been elected to lead the organisation for another term.

"By definition," he says, "no regulatory regime is ever finished."

Comment Why politicians cannot resist punishing risky behaviour

Roger Miles: blockbusting fines offer political theatre

Just three years ago, the UK's Financial Conduct Authority (FCA) undertook the task of regulating human behaviour. Previously, regulation of financial conduct had been incidental to the oversight of products and sales processes, rather than the explicit purpose of the regulator.

Today, the FCA has been joined by several faster-moving conduct enforcers in other countries, including Australia, Singapore and the US.

So-called behavioural regulation has been a hit with politicians around the world. It is easy to see why: conduct risk enforcement has become very profitable for governments. It is worth recalling how this came about.

Surveying the debris of the financial crisis, politicians urgently needed to reassert their authority and legitimacy. Voters, struggling to understand what had just happened, were feeling the pain of evictions, foreclosures and tax-funded bailouts. They began to turn their rage towards their elected representatives, who seemed to have lost control.

Casting around for a new template for regulation, public officials seized on an unconventional branch of science that seemed to offer hope: behavioural economics.

This suggested that by regulating the behaviour of financial marketers, rather than the products they sold, all would be well again. Behavioural "nudging" could also grant politicians the superheroic power to make big social changes without spending public money — achieving the austerity goal of doing more with less.

That same science, repurposed into financial regulation, has allowed governments to recoup billions of dollars in fines and restitution payments.

For politicians facing electoral meltdown, conduct-based regulation offers a fast track to rehabilitation. Blockbusting fines offer a form of political theatre, avenging consumers' suffering by publicly shaming individuals.

Thanks to a lower standard of proof, and sketchily defined offences, enforcers can quickly target a token senior manager.

While generating a heap of cash, conduct regulation also saves on agency running costs. By prosecuting individual managers, enforcers need not waste public money building a technical case against entire organisations or product ranges.

Best of all for governments, though, is the scale of the new fines.

Designed to punish perpetrators for customers' perceived suffering, these penalties deliver revenues to regulators that delight their cash-strapped political masters. Since the FCA came into existence, UK conduct regulators have handed out more than £3bn in fines and sanctions.

Other financial regulators around the world watched all this initially with polite interest, then with envy.

Behind the big headline fines, a subtler evolution is also going on. Just like the behavioural economists, the new enforcers are more interested in how real people interact during a sale than in the number or value of contracts transacted.

In a notable break with the past, the new enforcers are also global citizens, ready to travel wherever their behavioural know-how may be of value to reformist governments.

So we find the UK regulator recruiting from the Australian Securities and Investments Commission, the Securities and Exchange Commission in the US recruiting from the UK's FCA, and Hong Kong, Singapore and Australia poaching freely from each other's pool of behavioural enforcers.

There is also far greater co-operation among national regulators. For example, Australian research informs European guidelines, while the UK's Competition and Markets Authority consulted the Authority for Consumers and Markets of the Netherlands when it reviewed its retail finance practices.

For principled advocates of behavioural regulation, there is now a tension between its idealistic aims — to encourage good behaviour by regulated people — and the cold political calculus of how it is applied in practice.

As currently carried out, conduct control hands politicians a rare double win: a low-cost and tax-neutral way to reduce public deficits, with the populist bonus of pointing directly at named senior managers who until now might have appeared to have got away with it.

For the government of any country with an active financial market, these attractions are irresistible.

Roger Miles teaches at the University of Cambridge and co-edits the London School of Economics' annual Behavioural Economics Guides

Spain's biggest banks find salvation in global expansion

M&A

Santander and BBVA have benefited from their pre-crash investments in other markets, writes *Tobias Buck*

Spanish bankers remember 2012 as their annus horribilis.

It was the year when many of the country's banks finally paid the price for their behaviour during Spain's decade-long debt-fuelled property boom. Dozens of banks were first merged, then bailed out and nationalised, in a painful process that ultimately cost taxpayers more than €42bn.

It was a tough year for the nation's top two banks, in particular. Santander and BBVA were forced to set aside significant amounts of money to cover losses in their mortgage and loan portfolios in Spain, resulting in sharp falls in earnings. Their survival, however, was never in doubt — and neither was their ability to report billions of euros in group profits.

Santander and BBVA had behaved more prudently in their home country than some other lenders, especially Spain's regional savings banks. Even more important was the fact that they were no longer reliant on their home market alone. In the years leading up to the crash, Santander had worked ceaselessly to expand its reach across the globe — from Brazil and Chile to Britain, Poland and the US. BBVA had branched out into Turkey, the US, Mexico and a string of other Latin American countries.

When the big crunch came at home, the diversified portfolio of the two financial groups provided a critical cushion against the downturn in Spain.

"International diversification is what saved the Spanish banking system," says José María Roldán, president of Spain's AEB banking association. "This is not theory. This is what actually happened. We had 30 per cent of the Spanish banking system going bust but there was no contamination inside the upper tier."

> 'When the big crunch came, diversified portfolios provided a critical cushion'

José García Cantera, chief financial officer at Banco Santander, is an ardent defender of diversification. "When you look at our portfolio, the risk profile of the sum of the parts is lower than the risk profile of each component individually," he says. "That is a competitive advantage."

Mr García Cantera points out that not all players in financial services are in a position to manage risk through international expansion. "This only works because we are a retail bank," he says. "If you are an investment bank it does not work because investment banks are tied to financial markets and financial markets are correlated across the world."

Retail banking markets, in contrast, show little correlation — especially when, like Santander, a bank is active across different continents. According to its latest published results, the bank's two most profitable divisions were Britain and Brazil, two markets that have next to nothing in common. Each accounted for about a fifth of underlying group earnings, followed by Spain, the US and Mexico.

While several of Santander's leading markets have their troubles, these are mostly different from one another: the threat of a prolonged recession in Brazil, for example, or the risk of Brexit in the UK, or persistent low interest rates in Spain. These and myriad other risks may or may not turn into serious problems but, if they were to do so, they would be independent from one another — and play out over different periods.

Not so withdrawn: BBVA branched out to global markets – Bloomberg/Angel Navarrete

In the short term, says Mr García Cantera, diversification may limit the upside of a bank's presence in a healthy, fast-growing market. In the long term, however, it pays off. "If you are a Canadian bank right now, you are better off not being diversified," he says. "But what if you are a Brazilian bank? In good times we don't perform as well as a non-diversified bank. But we also suffer much less during bad times. You see the benefit over time."

If the advantages of the diversified model are clear, then so are the disadvantages. From a management point of view, banks like BBVA and Santander have repeatedly to prove to investors that they are able to manage their empires. Indeed, the depth of that challenge is clear from the exceedingly small number of global retail banks: the two Spanish examples aside, only HSBC and — to a lesser degree — Standard Chartered and Citigroup fall into the same category.

"Both BBVA and Santander have developed real expertise at managing their local retail operations while also using their corporate centres to scale up those things that are scaleable — from IT and risk management to helping the transfer of successful products from one market to the other," says Jordi Canals, dean of Iese business school, which has campuses in Barcelona and Madrid.

To be diverse but not distant is not easy. That has not stopped other Spanish lenders from trying. Banco Sabadell last year acquired TSB in the UK, while Caixabank bid for Portuguese lender BPI. Both have a long way to go to match the reach and diversification of the two market leaders — as do many of their non-Spanish rivals.

If the examples of BBVA and Santander are anything to go by, however, the pay-off could ultimately be significant — no matter when, or where, the next crisis hits.

The long road to EU-wide insurance regulation

Timeline of Solvency II

Insurance is not known for being a short-term business, and the introduction of a new European regulatory regime is certainly not a rush job. More than 30 years will have elapsed between the first moves to create a new regime and the final date at which all the rules are fully applied. Along the way there were plenty of delays — at one point, an industry quip had it that with each passing year, Solvency II was delayed by 12 months. The rulemakers also had to contend with the 2008 financial crisis and vociferous lobbying from the industry over the details.

The predecessor to Solvency II — Solvency I — had been introduced in the early 1970s, and insurance regulation across the EU was a patchwork of different national regimes. The new regime was intended to level the playing field by introducing a single system for insurers across the EU, and take into account new methods in risk management. In particular, it was supposed to make the calculation of assets and liabilities more sensitive to market movements and less reliant on standard industry models. It was also supposed to improve protection for policyholders.

By Oliver Ralph

Nov 2003
Creation of Ceiops (Committee of European Insurance and Occupational Pensions Supervisors). This body was the predecessor to Eiopa, the EU's current insurance regulator. It did much of the work designing the new regime

Jul 2007
European Commission adopts Solvency II proposal

Nov 2009
Solvency II directive passed by the Council of the European Union and the European Parliament

Jan 2011
Creation of Eiopa (European Insurance and Occupational Pensions Authority) as part of a wider shake up of financial regulation in the EU after the crisis

2012
Solvency II launch put back from Nov 1 2012 to Jan 1 2014

2013
Launch date put back from Jan 1 2014 to Jan 1 2016

Jan 1 2016
Solvency II launched

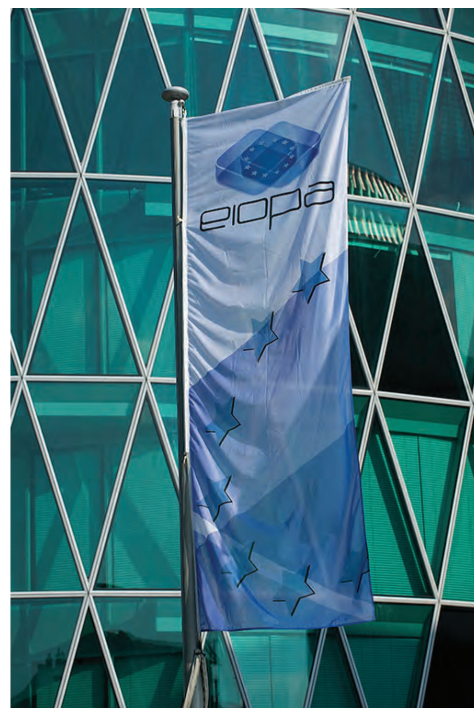
First half of 2016
Companies submit their first Solvency II reports to their national supervisory authorities

May 2017
First public disclosure of the Solvency and Financial Conditions Reports that companies should publish on their websites or in print. The reports will refer to the whole of 2016

2018
Eiopa to make proposals for a review of Solvency II

2032
Final transitional rules end. Regulators in many EU countries have allowed insurers to use transitional rules while they adapt their systems, assets and products to the new Solvency II regime

Charlie McCreevy, European Commissioner for Internal Market and Services (2004-10)



Eiopa headquarters in Frankfurt, Germany (left)
EU Commission headquarters in Brussels, Belgium (above)

FT graphic Source: FT research
Photos: Charlie Bibby; Getty

Insurance divides over shared rules

Continued from page 1

suggest a wide divergence between the companies. At the top of the pile, Germany's Allianz, France's Axa and NN Group of the Netherlands have all reported ratios of more than 200 per cent. At the other end, Netherlands-based Delta Lloyd has reported a ratio of 131 per cent and wants to raise €650m in a rights issue to strengthen its balance sheet.

The impact of Solvency II stretches beyond a single ratio. Over the long term, it will change the way insurers operate. "It is definitely changing business models because of the effect of the rules on new business," says Mr Prowse.

The biggest impact is expected in the life insurance sector, where Mr Prowse forecasts a shift away from insurers offering long-term investment guarantees, which carry heavy capital requirements under Solvency II.

UK annuity business is also changing. Those insurers still selling annuities are increasingly buying reinsurance for the longevity risks in order to reduce capital requirements.

The impact elsewhere will be less severe. "In general, Solvency II has fewer implications for non-life property and casualty business," says Mr Prowse. "Some products will cost a bit more, but people will carry on buying them, so the main impact will be on the customer."

Solvency II also influences the asset side of the balance sheet. All insurers

€650m
Amount Delta Lloyd needs to strengthen its balance sheet

16 years
Length of Solvency II transition period from Jan 2016

hold large investment portfolios to back the promises that they have made to their customers. Returns on these portfolios have traditionally provided a big chunk of their profits.

On the general insurance side of the business, where claims are unpredictable, companies tend to hold a lot in liquid assets. In the life insurance industry, however, companies have a lot more flexibility over where to invest. It is here that Solvency II has had the biggest

impact as the insurers aim to move away from assets that carry high capital charges under the new rules, but at the same time avoid assets whose returns are either tiny or negative.

In the much larger bond portfolios, those insurers that have offered long-term guarantees have moved towards gilts, but these offer very small returns. Others have therefore moved down the credit curve.

Infrastructure debt has been particularly popular. This offers better returns than government bonds and its long-term nature matches many insurers' liabilities.

However, not everybody has been able to invest. "There are access issues because liquidity and issuance aren't great," says Richard Sarsfield, head of European insurance at Morgan Stanley Investment Management. "Smaller insurers are struggling to access the market."

The Solvency II story did not finish on January 1. The transitional rules alone last for 16 years. As insurers get used to Solvency II, it is not only their products and asset portfolios that will change. Many are expected to buy and sell whole businesses as they reassess which ones work well in a Solvency II world, leading to a wave of merger and acquisition activity that started last year.

"It has definitely changed the way we do business," says Bart De Smet, chief executive of Belgian insurer Ageas. "We've divested small entities and we've bought some non-life companies."

The next few years will also see a formal review process. An assessment of some parts of the regime is due in 2018, although already the UK government has called for the review to be sooner and more wide ranging than had been planned.

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'Key person' exposure lessens as star managers fade

Investment funds Celebrity defections led to some damaging outflows, writes *David Ricketts*

Many fund companies have built up sizeable assets under management as a result of the stellar performance and status of top stock pickers.

As successful managers amass a large personal following, however, investment companies can soon find that they become a risk to their business, in that the once star players decide to set up on their own or move to a rival.

Bill Gross's move from Pimco to competitor fund group Janus Capital in 2014 is one of the most high-profile departures the fund industry has witnessed in recent years.

Mr Gross's exit from the US bond house he co-founded in 1971 prompted an investor exodus from his Total Return fund. The vehicle bled more than $120bn — representing 57 per cent of the fund's assets — in the year following his departure.

Jeremy Beckwith, director of UK manager research at fund rating agency Morningstar, considers that the explanation for Pimco's outflow woes was a simple one. "The problem with Pimco was that [Mr Gross] was the boss. He built himself a huge personal franchise and he convinced the world that he and Pimco were synonymous."

As outflows accelerated in the weeks following Mr Gross's departure, Pimco attempted to reassure remaining investors with an extensive marketing campaign to promote its new managers under the slogan "We are Pimco".

"What they did very quickly was tell the world they have a huge team of talented investment professionals," says Mr Beckwith.

Other fund houses have found themselves vulnerable to significant outflows following the departure of leading portfolio managers. Neil Woodford's announcement in October 2013 that he would leave Invesco Perpetual led to one of his former funds, Income, shedding 34 per cent of its assets. Richard Buxton's defection in the same year from Schroders to Old Mutual led his former UK Alpha Plus fund to lose 47 per cent of its assets.

Fund managers have taken notice of the impact that such high-profile departures can have and are beginning to hone their focus on succession planning, particularly where some individuals are responsible for a large portion of group assets under management.

Amin Rajan, chief executive of asset management consultancy Create Research, says fund companies vary greatly in how well equipped they are to manage key person risk. At some, succession planning is even seen as a taboo subject.

"At one extreme, it has proved hard to manage the risk for fear of offending the incumbents, who like to think that they are irreplaceable," says Mr Rajan. "At the other end, team culture is so strong that loss of key staff is not a big deal.

"In between lie fund houses where the star culture is weak and staff turnover is manageable, so key person risk is not an issue."

Asset managers that still foster a star manager culture often employ a particular approach to limit the risk of top talent leaving. "Investment stars like high rewards, peer recognition, regular career progression and light-touch management," says Mr Rajan.

"They like autonomy and space with minimal bureaucracy and hassle. They like to work with a boss they admire. These are the factors being implemented in many fund houses to limit the key person risk."

Other fund groups, adds Mr Rajan, are "overtly promoting team work that dilutes star culture" and reduces the potential risks.

Losing a star manager can prompt fund rating agencies to downgrade products until they are satisfied that asset managers have a credible succession plan and strategy in place.

Morningstar downgraded Invesco Perpetual Income and Invesco Perpetual High Income funds from gold to neutral following the departure of Mr Woodford. The funds have since been upgraded to bronze.

Schroders' UK Alpha Plus was also downgraded by Morningstar from gold to neutral following the defection of Mr Buxton. The fund maintains the downgraded rating under new manager Philip Matthews.

To reduce the risk of a flagship fund being downgraded, Alastair Sewell, a senior director at Fitch Ratings, says there is a growing trend for companies to emphasise teams of investment professionals over individuals.

"On the one hand, this is an effort to mitigate key person dependency. On the other, it shows a recognition of the benefits of cognitive diversity in decision making," he says. "Where there is a key person dependency, we see managers making strong efforts to inform the market and manage the transition when there are changes."

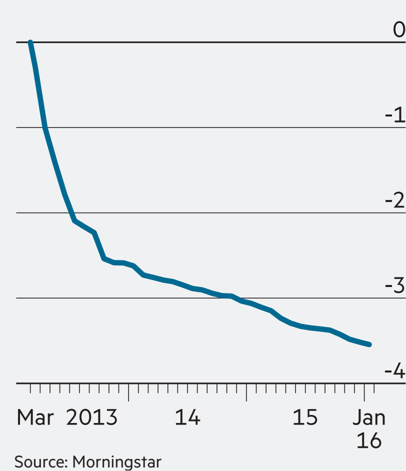
Given the high stakes involved when employing top fund managers, such individuals are at risk of becoming an endangered species themselves.

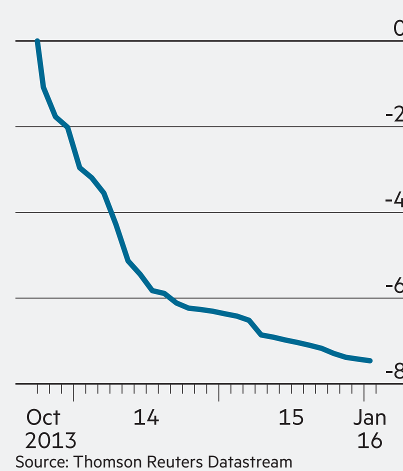
"Star culture is weaker now than ten years ago," says Mr Rajan. One reason is that consistent high performance is becoming harder for managers to achieve. "Star managers have had big ups and downs. This has created three categories: real stars, lucky stars and fading stars," Mr Rajan notes.

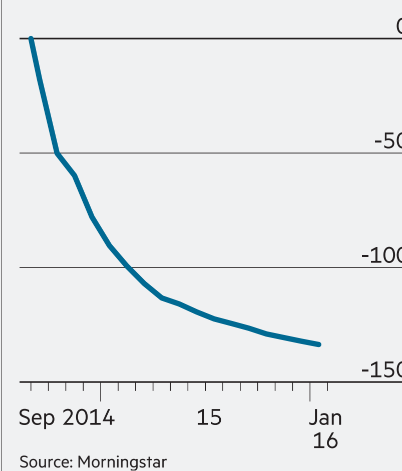
"The first category has been shrinking since the crisis. The other two enjoy shortlived success."

> Some fund companies consider succession planning a taboo subject

Four high-profile fund managers whose exits caused a stir







Regarded as one of the most successful UK equity fund managers, Richard Buxton quit Schroders for rival Old Mutual Global Investors in 2013.

Mr Buxton joined the FTSE 100 financial services group to help build its asset management capabilities, a move which has led to an influx of investor money to the group's funds.

Old Mutual Global Investors has seen assets under management grow from £15bn just before Mr Buxton's arrival to more than £22bn.

In addition to his fund management responsibilities, Mr Buxton last year became Old Mutual Global Investors' chief executive, replacing Julian Ide.

The appointment led some analysts to question whether Mr Buxton would be able to combine his daily fund management duties with additional leadership commitments.

Schroders suffered heavy investor withdrawals from its flagship UK Alpha Plus fund on the back of Mr Buxton's departure. The fund's assets under management almost halved in the eight months after news of his exit broke in March 2013.

The listed asset manager hired Philip Matthews from Jupiter as successor to the star stock picker.

Neil Woodford's Equity Income was the most bought fund by UK retail investors last year, a testament to his ability to attract investors in large numbers.

Before setting up his own fund management venture in 2014, Mr Woodford spent more than 25 years at Invesco Perpetual.

He oversaw £33bn of assets held in two funds when his departure was announced — almost half of the fund company's £70bn total assets at the time.

Mr Woodford's reputation as one of the UK's most consistent fund managers has earned him a loyal investor base and his flagship funds experienced significant investor redemptions when news of his departure broke in October 2013.

The Invesco Perpetual Income fund haemorrhaged $5.4bn (£3.8bn) in the 12 months following news of his departure.

Woodford Equity Income was the first fund launched by his new venture and attracted bumper inflows of £1.6bn in the three weeks before it started trading.

The £8bn vehicle is now larger than Mr Woodford's former Invesco Income fund, which was taken over by Mark Barnett.

Relations between billionaire fund manager Bill Gross and Newport Beach-based Pimco show no signs of improving since the industry veteran left for Janus Capital in 2014.

Assets under management at Pimco's Total Return fund, previously overseen by Mr Gross, have nosedived following the departure of the "Bond King".

In February, assets in Total Return stood at $88bn — a major comedown for a fund that managed $292bn at its peak in February 2013. The fund was already suffering heavy redemptions before the news broke that Mr Gross was leaving.

Mr Gross's Global Unconstrained Bond Fund at Janus has amassed assets of $1.26bn, although some $700m of this is his own money.

To make matters worse for Pimco, Mr Gross — who received a $300m bonus in 2013 — filed a lawsuit against his former colleagues last year, claiming he was wrongfully pushed out by a "cabal" of executives at the fixed income house.

German insurer Allianz, which owns Pimco, is keen to draw a line under the saga, with chief executive Oliver Bäte forecasting last month that the bond division would return to inflows by the end of this year.

Losing a star fund manager can be particularly painful for listed companies, which not only have to contend with fund outflows but also the knock-on effect a key departure can have on their share price.

US-based Waddell & Reed announced in February that Michael Avery, co-portfolio manager of its flagship Asset Strategy funds, will retire at the end of June.

The announcement, which coincided with the publication of poor fourth-quarter results, led the company's share price to fall 14 per cent in one day to an almost six-year low, demonstrating the importance shareholders place on such a fund industry heavyweight.

Mr Avery joined Waddell & Reed in 1981 and has overseen the Asset Strategy funds since 1997. The funds account for $21.9bn of the company's $104bn total assets under management.

Morningstar analyst Greggory Warren says Mr Avery's retirement is a "major blow for the firm". He adds: "His departure will lead to a greater level of near-term outflows and leave a leadership vacuum in the organisation, creating even more uncertainty for a firm that was already struggling to overcome . . . market volatility."

Things would be fine but for the workforce

People

Staff may rarely comply to standard models of risk, reports *Brian Groom*

Time and again, people have proven the weak link in risk management at banks and other financial institutions. Banks have made changes to recruitment, training, pay and monitoring to combat this — changes that will be tested if a global slowdown turns into a fresh banking crisis.

"There is still a tendency in banking to think that everything can be measured and that operational and people risk can be treated like any other risk — and I don't think it can," says Simon Ashby, a former regulator and finance industry risk manager who is an associate professor at Plymouth Business School.

After the financial crisis erupted eight years ago, it was initially the fallibility of banks' credit and market risk models that was exposed. These supposedly sophisticated instruments failed to cope with unprecedented market volatility.

After that, the industry was hit by a wave of operational problems, with human error at their heart. These included manipulation of the Libor benchmark interest rate and foreign exchange rates, losses by rogue traders and mis-selling of retail and small business products.

Arguably, people risk lies at the heart of all finance sector failings. It was people, after all, who designed the faulty credit and market risk models and it was leaders who created unsustainable business models that led to the downfall of institutions such as Northern Rock and Lehman Brothers.

"Ultimately, it is all about people. The management of people risk is totally and fundamentally dependent on the culture of the organisation," says Paul Hopkin, technical director at the Institute of Risk Management, which has members in more than 100 countries.

Rogue trader: Jérôme Kerviel cost Société Générale €4.9bn in 2008
Reuters/Philippe Wojazer

Mr Hopkin credits the industry with making substantial efforts to clean things up, prompted in large part by regulatory pressure.

Companies have stepped up training. Mr Hopkin says the IRM has seen a surge of interest from banks in running its general risk awareness courses at all levels, as well as continued popularity for its specialist financial sector certificate.

Vishal Vedi, financial services risk partner at Deloitte, says banks have introduced mandatory programmes of face-to-face and online training, covering how to treat customers, how staff are expected to behave and how to spot wrongdoing.

Banks have changed pay and reward systems that were considered to have encouraged undue risk taking. For high-earning staff, bonuses have been deferred and more paid in shares rather than cash. The EU capped bank bonuses at 100 per cent of salary, or 200 per cent with shareholder approval. UK rules allow banks to claw back top managers' bonuses for up to 10 years.

> 'When times are hard, it's easy for this kind of softer stuff to go out of the window'
>
> Simon Ashby, associate professor at Plymouth Business School

At junior levels, some banks have shifted criteria for awarding bonuses from sales to customer satisfaction. "The vast majority of banks have put in place extensive efforts around risk culture and treating customers fairly," says Mr Vedi. "That is increasingly being reflected in how banks assess and appraise people."

Risk issues now often feature in recruitment interviews. Much of the hiring done since the crisis has been for risk and compliance managers, driven by regulatory requirements.

Aside from cultural changes, there is increased monitoring, particularly to prevent rogue traders from going undetected. Investment banks are making traders take a minimum holiday period so any problems can be uncovered. Traders' risk limits are monitored and trading data sifted to identify suspect transactions.

UK regulators have introduced a "senior managers' regime" aimed at holding bosses to account for failings on their watch, alongside a certification regime, which requires lenders to assess and certify whether individuals are suitable according to particular rules. Another set of rules governing the conduct of junior staff comes into force next year.

Prof Ashby says the finance industry has made progress but he fears that could be threatened in a tougher economic climate. "When times are hard, it's easy for this kind of softer stuff to go out of the window," he says. He also detects an element of fatigue, with some bankers thinking they have "done" people risk.

"They need to continue to invest time and money into it," he adds.

REDEFINING RISK MANAGEMENT

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