FRIDAY VIEW

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Solvency II: The Unintended Consequences

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Solvency II, the regulation aimed at establishing a revised set of EU-wide capital requirements and risk management standards that will replace current solvency rules, has as its prime objective the reduction of the impact of future market crises on the insurance industry. This is sensible and necessary, especially given the current environment of economic and market uncertainty relating to the recovery from the most recent crisis. However, such regulatory initiatives are having a very real and adverse impact upon the assets held by insurers that are still in the process of post-crisis recovery.

When endeavouring to increase the liquidity profile of insurers' balance sheets, a method favoured by regulators is to increase the capital adequacy requirements associated with less liquid assets. As a result of shareholders' return on capital expectations, insurers are re-evaluating the merits of such balance sheet utilisation: considering the yield expectations of holding illiquid assets in the context of the increased cost of capital. One notable result of this exercise has been the recent disposals, by insurers, of their private equity divisions.

In addition to the increase in supply of less liquid assets, the new regulations are also reducing the market's demand: Solvency II reduces the level of bank debt that can be held by insurers (insurers have been historically one of the largest consumers of bank debt). With the reduction in demand for bank debt, banks will find it increasingly difficult to recapitalise, in an environment where they are facing their own regulatory pressure to increase capital adequacy levels under Basel III. This will reduce banks' lending levels, which will negatively impact economic growth, dampening demand.

This is clearly evident with assets such as illiquid hedge fund shares. Regulatory pressure is increasing the supply of such assets, whilst the pressure on banks to recapitalise is reducing the flow of credit, thereby reducing demand. Conversely, the lack of demand for such illiquid assets is depressing the prices, thereby increasing the yields attainable for buyers. As an asset class, illiquid hedge fund shares have only been prevalent since the financial crisis, and are increasingly sought by buyers such as sovereign funds, pensions and family offices – i.e. those who are less impacted by the current regulatory initiatives, and by potential pressures from investor redemptions. Buyers are attracted to the significant yields that are often available in the relatively inefficient hedge fund secondary market. Such inefficiencies provide opportunities, and at Gamma Finance we have already seen $2-3 billion deployed in dedicated portfolios over the past twelve months, with investors continuing to raise substantial capital to finance further acquisitions.

This new asset class of illiquid hedge fund shares – created by a financial crisis and prolonged by on-going economic uncertainty and regulatory changes – currently totals around $50-$70 billion. The inefficiencies, caused by imbalances relating to asset volumes (large volumes of supply and relatively low demand), market participants (considerably more sellers than buyers); and information (far more hedge funds that are being sold than those with which buyers are familiar), can be mitigated through a tailored approach which blends an understanding of the assets, with an ongoing relationship with the market participants.

In this context, our work with insurance companies highlights the consequences of the current regulatory changes – and the difficulties faced by regulators in striking the right balance between the often competing objectives of supporting economic recovery, whilst also preventing future crises.