The choice to outsource – creating operational efficiency and reducing risk

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Insurance companies' investment businesses face a perfect storm scenario. A low interest-rate environment has led to the hunt for better returns, which in turn has driven insurers to adopt new and more complex investment strategies, expand into new markets and increase their allocations to particular alternative asset classes. At the same time, the industry faces an increasingly complex regulatory landscape, with global initiatives subjecting insurers to a range of requirements that bring administrative burdens, reporting demands and potentially costly systems investments.

Insurers' investment operations departments are among the areas in which the effect of these forces will be most acutely felt. In the long term, current systems of oversight, processing, reporting and administration may prove to be inadequate to meet the resulting challenges.

The questions are: Does the insurance industry have the right operational systems infrastructure in place to maintain efficiency and manage risk? How will insurers meet the requirements of this increasingly sophisticated and constantly-changing environment?

Regulatory Change and the Rise of Alternatives

With global regulatory initiatives continuing at the current pace, insurers will be subject to a range of requirements that will dramatically swell the levels of data processing, aggregation, transparency and reporting they are expected to undertake. These include:

- Dodd-Frank legislation, which regulates firms that could pose a risk to the financial stability, extends regulatory coverage to non-US financial service companies operating in the US and affects US or foreign nonbank financial companies (NBFCs) designated as systematically important by the Financial Stability Oversight Council (FSOC). Perhaps the biggest impact on insurers stems from measures introducing central clearing for over-the-counter (OTC) derivatives, as many use these instruments for hedging purposes against investment risks, from interest-rate to longevity risk.
- In Europe, regulators have taken new steps to make sure insurers are able to meet their claims. Solvency II imposes additional capital requirements and regulations on governance and risk management and requires more disclosure to identify risks earlier.
- The EU's Capital Requirements Directive IV and Alternative Investment Fund Managers Directive (AIFMD) will require new restrictions on the way asset managers are remunerated.
- The EU has also launched Undertakings for Collective Investment in Transferable Securities (UCITS) V, which has led to a new series of regulatory initiatives for companies operating in Europe.
- In the UK, the Markets in Financial Instruments Directive (MiFID) II and the Retail Distribution Review (RDR) have set up a new set of requirements focused on encouraging greater transparency and giving lower-priced investment products a competitive advantage.

In the effort to improve returns, insurers have explored new markets and alternative asset classes. These may include:

Bank loans – A recent survey of chief information officers and chief financial officers of insurance companies reported 43% would increase their allocation to bank loans[1], a significant increase from previous years and a trend potentially bringing significant operational impact.

By their nature, the processing of bank loans requires significant manual intervention, with the requirement for correct documentation and robust controls on operational structures being critically important. Accounting, settlement and valuation processes are all more complex than is the case when investing in more traditional funds and asset classes. Consequently, ensuring the correct cash flows are captured and recorded takes on particular significance, requiring servicing expertise that the insurer's operations team may not necessarily have.

Real estate – In the same survey, 37% of respondents said that they intend to increase their allocation to real estate. Investing directly in property rather than through funds brings a higher degree of operational and administrative

1. *Source: GSAM Insurance Survey 2013*

complexity. Compared to investing in 'traditional' asset classes such as equities, purchasing a property asset involves more counterparties – there is usually a property agent, an independent valuation agent, a lawyer and tax advisor involved in each transaction. There is often also a requirement, particularly for cross-border assets, to establish nominee companies such as special purpose vehicles to hold the property investment.

Consequently, accounting systems with strong workflow processes are vital to support the different partners involved in each transaction, to handle the quantities of documentation and also to ensure that decision-making in the appropriate legal entity is never compromised

Catastrophe bonds and insurance linked securities – The market size of this asset class has increased significantly since first being issued in the early 1990's, with 2012 bringing new issuance of more than US$6 billion and US$4 billion in the first half of 2013 alone[2]. As these figures suggest, more insurers are issuing these securities to spread risk, with their popularity being because investors receive a premium for taking on specific insurance risks (e.g. earthquakes or hurricanes), which are for the most part uncorrelated to risks and returns in the equity and bond markets.

Any insurer considering issuing these instruments must ensure they hold appropriate collateral and manage claims, reserve processing and contract management. Again, not all are likely to have the systems and processes currently in place to carry out these functions currently. At the same time, those looking to invest in insurance linked securities (life insurers and reinsurers have been among their users) should be prepared to treat them as alternative investments for servicing purposes, with the additional complexity inherent in this asset class.

The Efficiency Challenge

Insurance companies are coming under pressure to develop and support new product and delivery platforms demanded by changing investor needs. And they must do this as revenues have remained flat and the cost of maintaining legacy systems continues to rise. The combination of a more complex regulatory environment and increasing investment sophistication is likely to lead insurers to question the adequacy of their operational oversight. In addition, the levels of processing and administration required – both for investments and data – will place operational infrastructure under severe pressure. Robust systems, enhanced levels of control, and the ability to deliver and draw upon accurate and timely data will be required. Insurers may find that their legacy back office systems cannot manage compliance requirements, monitor risk management and report on investment performance to the level that is required.

Insurers who believe that they can solve technology challenges on their own need to look beyond their industry at the way other companies are dealing with similar challenges. In most cases, those companies are working with outside vendors to both modernize their systems and reduce their costs. Many asset managers at investment management firms have taken active steps to meet the demands for greater operational efficiency, increased transparency and better risk management from regulators and investors. Their move to outsourcing has come in two phases: In the first phase, many investment firms decided to focus on investment and distribution issues, letting other firms deal with the challenges of supporting back- and middle-office systems for their equity and bond investments. In the second wave, investment firms have begun to outsource systems for derivatives, private equity and other complex securities, as well as systems that manage fund accounting, trading and settlement, and collateral.

By way of example within the insurance industry, regulatory reporting for an insurer with a multi-manager investment model is likely to be an arduous and complex process in which the ability to store all asset-related data in one place will be a significant advantage.

In such instances, outsourcing the data aggregation elements of this process to an asset servicer, thereby reducing the need to undertake complex reconciliation tasks, may present a solution to this challenge. At the same time, integrated regulatory reporting solutions may also be provided, helping insurers' ensure compliance with regulations, meet their reporting requirements and avoid penalties.

Our experience is that insurers are already considering the many challenges they face. Some are looking to third parties to help manage their non-core activities and provide specialist support in areas where they have limited in-house experience or expertise, while others are considering in-house investment in new systems. In addition, the use of similarly integrated platforms that recognize all required asset classes, from real estate to bank loans, and which allow multiple clients in multiple markets to be supported, are likely to become more commonplace in supporting insurers' evolving investment strategies.

Now is the optimum time for insurers to decide how their operational structures may be developed to meet tomorrow's challenges.

2. *Source: Swiss Re, Insurance Linked Securities Market Update, July 2013*