Is an overarching trend for outsourcing of operational infrastructure and investment processes emerging and what are the benefits and pitfalls?

Moderator

Alton Cogert
President & Chief Executive Officer, Strategic Asset Alliance

Panelists

Anthony Minopoli
Chief Investment Officer, Knights of Columbus

Celia Kapsomera
Vice President, Risk and Investment Management, GLOBAL Reinsurance Corporation of America

David Sullivan
Insurance Practice Leader, Americas, Northern Trust

Alton Cogert: Thank-you to the panel for joining me for this debate.

Our first question we have is, over the past 10 years asset managers around the globe have outsourced their back and middle offices in an effort to reduce cost and operational risk. This has allowed them to focus on asset management, performance returns and entry into new investments and markets. As an asset manager for an insurance company, do you outsource? What is your experience? If you do not currently outsource, what are your thoughts around it?

Celia Kapsomera: My company has been outsourcing its investment activities in the US including trading and portfolio management to two asset management firms since the US subsidiary was established. One of the firms also does GLOBAL Re's investment accounting; a custodian holds its securities; a trustee holds its pension assets; reconciliation with the company's general ledger is done by an internal investment accounting unit. Surveillance, performance monitoring and management reporting is also done internally. In the past, when the company was active -we are in runoff right now- some private placement investments and cash management were done by an investment officer internally.

Our experience with outsourcing has been positive. For GLOBAL Re it has been more cost effective to outsource these functions than to perform them internally. An investment firm has specialized knowledge and resources that a small in-house staff of investment professionals cannot replicate. The increasing complexity and the broader diversity of investment portfolios, which now include alternative investments, require greater analysis, due diligence and monitoring. The difficult environment in the capital markets since 2008 has brought risk management to the forefront, requiring us to spend more time in this discipline and to search for specialists with specific knowledge such as understanding the pitfalls of the ("Mortgage-Backed Securities") MBS market, knowledge that we did not have internally.

Alton: What's the size of the portfolio of Global Re?

Celia: It started from \$1bn and it is now down to about half a billion.

Anthony Minopoli: We are a \$21bn organization. We handle all of our middle and back office functions in-house. To date we have implemented a lot of straight through processing and a lot of technology to automate back and middle office and it's been quite successful. We've been able to turn human resources there to become more analytical in their day to day jobs because it's less clerical focused which has been a benefit for the organization. We do outsource some small portion of our asset management, mainly some of our equities, a little preferred stock and alternatives but in total it's probably about 92% in-house and about 8% externally managed. We have found that the efficiencies we have in-house are controlled by managing the whole process front, middle and back office internally. We think the control far outweighs the perceived savings that can be generated by placing everything outside. Until it becomes too onerous, our game plan is that we'll keep them as internally generated assets.

David Sullivan: Broadly speaking we've seen a tremendous amount of growth in outsourcing of middle and back office services. One of the fastest growing areas of our business globally is servicing the needs of asset managers. This is due to asset managers looking to revisit their operating models and make improvements. One of the main drivers for this is that there's an increase in complexity and costs in the business. Our model, which has been validated throughout our business, is that more and more managers are focusing on a core investment expertise. They are looking to partners to manage the growing complexities of the business driven by leading edge technology, increasing regulation and entry into new and non traditional asset classes.

Alton: How would you describe the current regulatory environment for insurance companies? What pace of change do you expect in regulation over the next 5 years?

Celia: The intense regulatory work continues to evolve. Insurers continue to face economic challenges with persistently low interest rates and insurance products pricing pressure. In the US one can distinguish the development of regulatory issues into three areas:

- **International** - Regulatory developments outside the US that impact US insurers, which have international operations. For example, Solvency II and the international agenda of the Financial Accounting Standards Board ("FASB") and the International Association of Insurance Supervisors ("IAIS")
- **Federal** - These are extensions or enhancements of the Dodd Frank Act and include the creation of a Federal Insurance Office, some oversight by the Federal Reserve, and the potential designation of some US insurers as Significantly Important Financial Institutions (SIFIs). Examples are AIG and most recently Prudential, which is contesting the title.
- **State** - Lastly but most importantly, because that is the main regulatory body of the insurance industry in the US. Basically, these are National Association of Insurance Commissioners' ("NAIC") enhancements to risk management requirements via the adoption of ORSA and a new review of the Risk Based Capital calculation. NAIC is also coordinating a review of the Solvency Modernisation Initiative.

These initiatives will have repercussions in several areas. They can cause strategic repositioning and restructuring, for example, re-domestications and acquisitions of business portfolios. They will increase the oversight by several regulating bodies in contrast to the current state-dominated supervision. Updated RBC requirements to include charges for catastrophe and operational risks are under consideration. Finally, there will be requirements to develop risk programs across all risk types, not only insurance risks, as has been the case historically.

Alton: It sounds like the pace of change over the next five years is increasing?

Celia: Definitely.

Anthony: Obviously it's always the regulatory challenge. We operate both in the US and Canada. Canada has a federal oversight level for insurance, where as we all know in the United States it's really governed by the insurance commissioners and a State group in terms of their rules. Obviously though, it's a lot more than having a single regulator. We've been a little in front of ORSA because Canada is a little further down the road with adopting it. We've been working a lot on the preparations and we're pulling that together now. We'll be ready for the US's accounting and capital challenges, in terms of different calculations and the amount of testing. We see both regulatory compliance with regulatory analysis taking on a much larger portion of our day to day operations. I spend more time today than I did five years ago working with various committees inside the company to ensure that we're keeping up with changes in regulation, not to mention capital and accounting changes as well.

"The difference in the US is that you can get pulled up by a state regulator if the font of the contract cover is 11 versus 11.15 versus 12!"

Alton: Let me add a question for you, Canada and the US is where you operate, Canada being more of a federal system and the US primarily still being a state based regulation. Is one easier to work with than the other?

Anthony: They both have their challenges but with Canada it's one set of rules, particularly when you're thinking about putting the product development side on. When you're coming up with a new product you basically present it to one regulator and get them to stamp it to say, 'okay, it's approved for sale'. The difference in the US is that you can get pulled up by a state regulator if the font of the contract cover is 11 versus 11.15 versus 12! It does get into that level of minutia. That's a bit of an extreme example but it has come up previously. It is easier to deal with one regulator as opposed to many but they're both fairly consistent with the aspects of regulatory compliance that are important to them. I wouldn't mind it if we had a single federal commission that covered all 50 states and insurance regulations were uniform across the country. It would make compliance a little bit easier as there are a lot of little things that are not necessarily major issues. You have to go back and make sure you dot all those i's and dot all those t's.

Alton: David, how would you describe the current regulatory environment for insurance companies? What pace of change do you expect in regulation over the next 5 years?

David: I would absolutely agree with Tony and Celia in their characterization of the regulatory environment as evolving, complex and with an increasing pace of change. None of us see those factors reversing any time soon. This is an area that we are very sensitive to. Northern Trust is a global bank and asset manager and we have been operating in this environment for some time. Certainly one of the underlying themes, regardless of the type or nature of the regulation, is the need for data transparency. There are a lot more demands from the various regulatory bodies for more data that is both accurate and timely both from a regulatory perspective and from an internal risk management perspective. That's certainly something we see in insurance specifically and also more broadly throughout asset management.

Alton: You mentioned risk management there. It seems to be a theme that everyone has mentioned and is behind a lot the issues we've talked about. What additional stresses do you feel are being placed on your investment processes and infrastructure and how are you responding?

Anthony: Because of the low interest rate environment we are just one of a few firms that are still rated double A+ by Standard & Poor's and A++ from A.M. Best. Maintaining the highest rating that an insurance company can have is exceedingly important to us, so obviously that puts some pressure on investment strategy. In terms of processing, we are not a user of derivatives. Keeping off some of the accounting, we haven't really had any major middle or back office stresses that I would say are of consequence to the discussion we are having today.

Celia: My views are similar to Anthony's. As a runoff company we are more interested in capital preservation and liquidity than higher returns, so we are not doing anything very sophisticated in terms of derivatives or alternative assets. If I am to answer the question about insurers in general, I would say that as insurers are searching for more yield, they are looking for alternative assets and into emerging markets. The complexity of non-traditional investment products and the challenges of slower pace or more cumbersome regulations in less developed countries, pose additional stress to an insurer's investment process and even infrastructure. One way of responding is outsourcing the more specialized system capabilities to custodians who offer value added services, and/or outsourcing specific knowledge to additional asset managers or consultants. Insurers who have these kinds of issues and are going more towards emerging markets need more help from the outside.

Alton: To follow that point you made, as companies deal more and more with low interest rates they are looking at different asset classes. That plays into exactly what you were saying.

Celia: Alternative assets and emerging markets are the two areas that a lot of insurers are looking at right now. Not us, but it is what I hear from colleagues.

Alton: David, what are your thoughts on those stresses?

David: I would say our perspective is similar to Celia's. We see many insurance companies becoming more esoteric with their investments, both in terms of exploring alternatives as well getting into asset classes that they haven't been in previously. Some are doing it via in-house capabilities from an asset management perspective, some are partnering with third party asset managers. Regardless of the method in which this is performed, clearly this does place additional demands on the business as do the regulatory and competitive pressures. Again, this is consistent with the overall theme of increased partnering with third parties in various capacities to manage the evolving complexity in the business in an effort to contain cost and manage risk.

Alton: I'm assuming that Northern Trust has a rather broad experience in some of these asset classes that we've been talking about: emerging markets, alternatives and investments like that?

David: Absolutely. Our business is quite broad in terms of the types of clients that we work with. As an organization we are extremely focused on insurers as a segment of our business. We have been servicing insurance companies for 40 years. We also benefit from being a large organization with many types of relationships with various asset managers and asset owners such as sovereign wealth funds. Foundations, for example, come from a different perspective, in terms of asset allocation and are bigger investors in alternative asset classes and in emerging markets. As our insurance specific client base begins to evolve towards, but not necessarily to the same degree as, foundations, then many of the experiences that we have working through those client segments will be directly applicable to our insurance clients.

Alton: How have you responded as a company to advancing technological developments?

Anthony: One of the developments has been an embrace of technology. Our investment department is virtually a paperless environment now. We use a straight through processing system for our trade orders, so if one of the Portfolio Managers executes a trade, an order gets electronically sent to the desk. The traders will then convert the order into a ticket to execute, the trade is sent to our desk assistant who clears the trade. Everything is done and automatically updates our ledger system, sending a confirmation out to the broker and custodian. Not a single piece of paper is generated. We've streamlined the process; we haven't had to add bodies plus we took the bodies that were focused on that and gave them a chance to upgrade their day to day existence, in terms of becoming analysts on the desks as opposed to just clearing trades.

On our research platform, we've used an archive system, so we can scan all documents that come in. Any credit or investment we have in the portfolio can go right to that spot and literally find anything that we used in our research process that was externally sourced. This is as well as looking back at an archive of every written credit review we have and any name, whether it's in the structured book or the credit book, to see what we thought on those companies at various points. It could be mergers, corporate events, and earnings so we've used it and continued to embrace it.

Celia: I will approach the question from two sides; from a runoff company's perspective and from what I think insurers generally are facing. As a run-off company which does not produce any premium revenue, it is possible to be left behind in technological developments since usually there are no adequate funds to replace or upgrade systems or to add staff. We have been able to maintain and operate with what we have and we have done some software upgrades but that's about it. This is still effective as long as a major failure does not occur. Besides, speed of processing is not the biggest concern for runoff insurers.

In general, however, the investment management process is now far more time-consuming and resource-intensive than it has been in the past. Given the increased diversification of portfolios and complexity of assets, insurers, and indeed all investors, need to rely on specialists for different product types and specialized knowledge and skill sets. An insurer usually does not have such breadth and depth of knowledge as the specialists unless it is a very large, global player or it owns an asset management firm. For example, Allianz owns Pimco or Axa owns AllianceBernstein. Often insurers use not only investment managers but also consultants to help select the investment managers and maintain a risk management process. I understand that there are four predominant types of consultants; the traditional ones, who advise on establishing and maintaining investment policy, they screen investment managers and sometimes also select investment managers, if they are cross-over or implementation consultants. Another type would be global financial institutions/asset managers. There are two categories: those offering a broad menu of investment products managed internally by proprietary investment teams and those who are managers of managers. The latter create different investment funds, each having multiple managers with complimentary and diversifying investment strategies. A third type would be multi-asset funds, who provide a single model portfolio, in a sense "one size fits all". Lastly, we have the outsourced investment office or the outsourced Chief Investment Officer. They provide a custom solution for each client based on needs, risk tolerances and return targets. These are the predominant types of consultants that are helping US insurers navigate the landscape of investment management if they don't go directly to the asset manager themselves or if they need more help. We are not one of those. As a runoff company we are directly interfacing with our asset managers and they do our investment accounting as well. We only do the monitoring and the risk management in-house.

David: I would say our technology spend is very large, growing and client directed as we work with our clients specifically in insurance and understanding the underlying industry and the changes. We deliver solutions across a single operating platform that is global, scalable, efficient and flexible. One integrated technology platform for all our clients ensures that our technology spending is focused on developing our capabilities rather than integrating, reconciling or maintaining multiple systems or data points. This strategy allows us to bring new system enhancements to market more quickly, as each enhancement is only developed and implemented once. It is complimented with industry expertise to understand the environment that we're in, what the evolution will be, what it has been and will continue to be and making sure that our spend is directed appropriately. I would also add that in this area specifically, scale is tremendously important as costs are increasing significantly in this area with the increase in complexity in the business.

Alton: On that final note we'll conclude. I'd like to thank all the participants for their time and sharing their views.

"our technology spend is very large, growing and client directed . . . "