INSURANCE ASSET MANAGEMENT, NORTH AMERICA 2015

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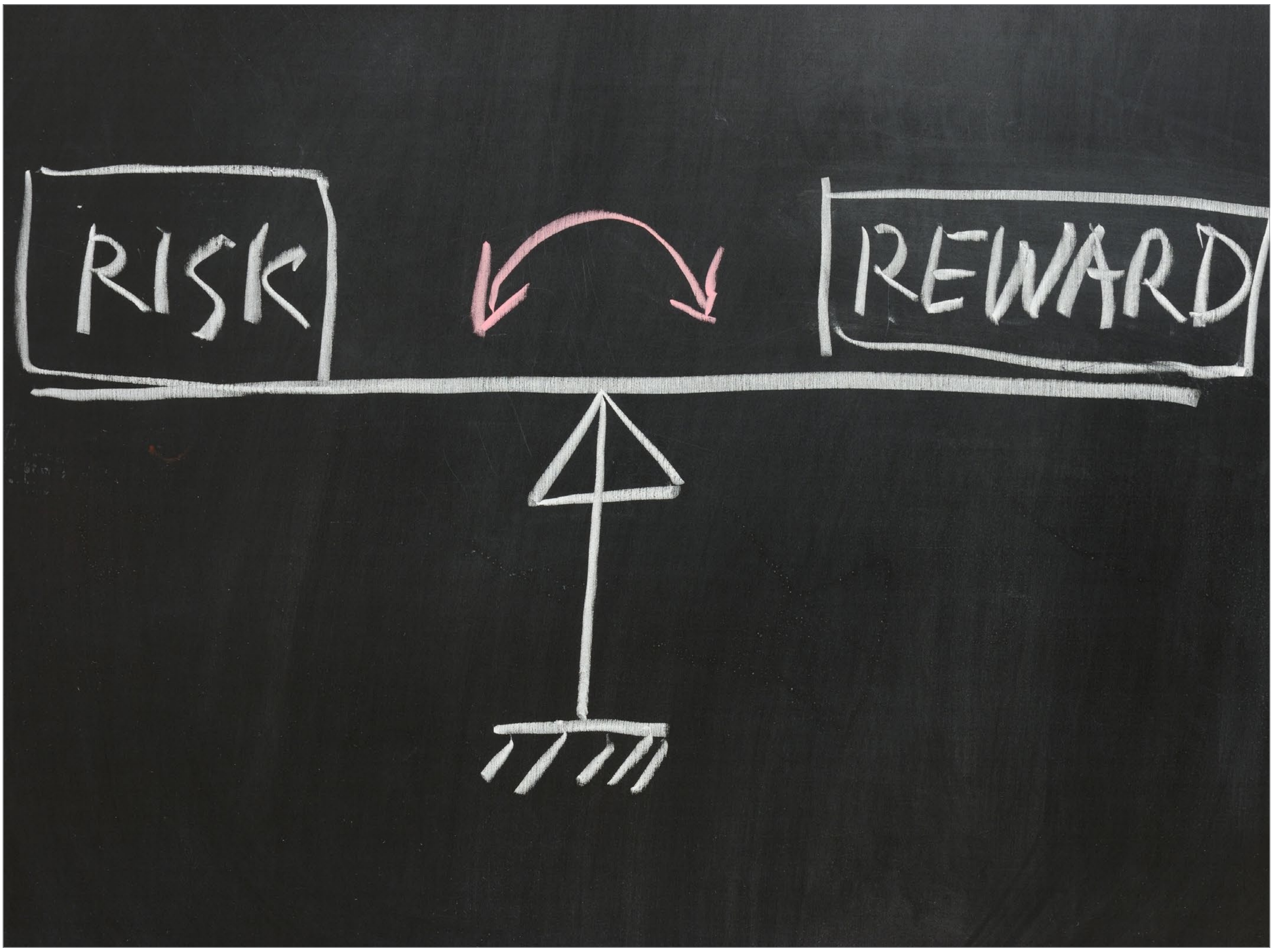


Examining the challenges of driving yield and improving investment operations as a North American insurer

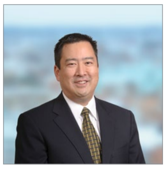
CONTENTS

Insurance Asset Management, North America 2015

Edward Toy
Director, Capital Markets Bureau, National Association of Insurance Commissioners

Paul Fahey
Senior Vice President, Relationship Management, Northern Trust

Anthony Grandolfo
Chief Investment Officer, Validus Holdings



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Senior Managing Director, Global Head - Insurance Business Development, AllianceBernstein

CONTENTS

Insurance Asset Management, North America 2015

Krishnan Ethirajan
Chief Operations Officer, IronServe, Ironshore Insurance

Rip Reeves
Chief Investment Officer/Treasurer, AEGIS Insurance Services

Shawn L. Sylvester
Senior Vice President, Global Business Services, Endurance

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FOREWORD

The Data Challenge: overcoming the hurdles

Paul Fahey
Senior Vice President, Relationship Management, Northern Trust

Today, insurers are faced with ever-increasing amounts of data. Whether it is generated internally, or sent to them from outside parties, insurers are challenged to make use of the myriad amounts of information flowing through their systems. Managing it requires a well-thought out plan administered by professionals who understand the importance of data strategy. Access to more accurate information can lead to improved business decision making, operational efficiency and reduced risk.

What are the challenges?

We all need data to perform our jobs. Whether we use it for investment decision-making, regulatory reporting, internal reporting, asset modelling or otherwise assessing risk, having access to information is crucial in performing everyday tasks. Investment professionals recognize that the process of obtaining useful data is one of their greatest obstacles. What are the some of the challenges in obtaining data that is useful? According to a recent survey of insurers and investment managers conducted by the Economist Intelligence Unit ("EIU") and sponsored by Northern Trust, these were the most frequently cited.

- **The cost of obtaining data is prohibitive** – The cost of acquiring useful data can be insurmountable for many companies. Years ago, the greatest cost was in data storage. Today, those costs have dropped significantly. The greatest expense now lies in the costs of acquiring data, ensuring it is compatible, scrubbing it, regulating it and managing the risks around sharing it.

- **Data is presented in non-compatible formats** – Data is crucial, but you need to be able to make sense of it for it to be useful. Many insurance companies run on older systems that may not be compatible with newer programs. In addition, not all data is available in formats that can be easily translated.

- **Data needs significant scrubbing** – According to the survey, nearly a third of respondents felt that the most significant difficulty in getting and sharing data is the fact that it requires significant processing or scrubbing. This process is both costly and time-consuming as it requires dedicated resources that can better be used elsewhere.

> "Determining a data strategy is both a technology and a business challenge"

- **Data does not arrive in time to be useful** – As new sources of information become available and access to it improves, expectations around the availability of the data increase. Information that was once acceptable on an annual or quarterly basis is now needed monthly or even daily.

- **Data is irrelevant to current needs** – Today, information needs change quickly. The pace of financial, regulatory and investment change means that data must keep up in order to remain useful.

- **There's too much data** – Today, the insurance industry has access to information sources that were simply not available thirty years ago. These include vendors and other third-party providers, but other sources include unstructured text, such as social media, mobile devices, telecommunications, search results and other items that exist outside of automated system interfaces.

These challenges, while numerous, are not insurmountable with the right structure in place to help manage them.

Defining data's role in your company's overall strategy – is it a technology challenge or a business challenge?

Determining a data strategy is both a technology ***and*** a business challenge. Technology decisions that are integrated into the business strategy can be applied across the organization. Businesses can operate more effectively with information and technology that allows them to make better decisions, be more efficient, and find better ways to service their clients.

So why is an enterprise-wide data strategy so important? Of the companies surveyed, more than half said their data strategy improves their investment decisions, while nearly 45% cited risk management as a key reason for developing a data strategy. Other goals listed included improving internal and external reporting, modelling or otherwise assessing risk, supporting decisions for product marketing or distribution, and managing costs. These goals cross multiple business lines, touching every key business function. The most effective strategy will define how data is collected, used and distributed on an enterprise-wide basis, reducing redundancies and allowing each business unit to benefit from advances in technology.

Importance of a centralized data governance structure

A key component of successful data governance is centralized decision-making. Whether this responsibility falls to a Chief Information or Technology Officer, or other senior-level managers, decisions around technology strategy should be made by a person or team that has a holistic view of the company's needs and the ability to collaborate with different levels of the organization. However, fewer than 25% of the companies surveyed said that their data strategy plan is developed by a chief data officer, while more than a third said there is no central leader. Without this centralized decision-making, a company is exposing itself to increased risks and missed opportunities.

Establishing a process for review of the data strategy

A data governance strategy must be flexible and must be reviewed at least annually to be successful. Technology is constantly changing, new sources become available, and a company's needs fluctuate over time. When asked how well their company's data strategy was prepared to meet current challenges and opportunities, approximately two-thirds of respondents to the survey said their strategy was well-prepared. However, when asked how flexible their company's strategy was to respond to unexpected challenges or opportunities, nearly 40% reported that their strategy was only somewhat flexible. To be effective, the data strategy must be changeable over time and pertinent to current business needs. Without this, companies may miss opportunities to improve the way their business interacts with the world.

There are certainly significant challenges to obtaining and making use of information. These challenges require the correct processes to ensure that data is managed efficiently and effectively on an enterprise- wide basis. Having the correct people in place and global operating model working within a data governance structure can help insurance companies overcome the hurdles.

"fewer than 25% of the companies surveyed said that their data strategy plan is developed by a chief data officer"

SECTION 1

WELCOME TO THE NEW NORMAL

1.1 INTERVIEW

A regulatory outlook for 2016: what should insurers take heed of?

1.2 ROUNDTABLE DEBATE

Operating in the 'new norm' of low rates: how should insurers go about identifying income whilst avoiding overstretch in the search for yield?

1.1 INTERVIEW

A regulatory outlook for 2016: what should insurers take heed of?

Interviewer

Noel Hillmann
Managing Director, Clear Path Analysis

Interviewee

Edward Toy
Director, Capital Markets Bureau, National Association of Insurance Commissioners

Noel Hillmann: How will and should regulation, as it relates to insurance asset management, evolve in 2016?

Edward Toy: The most important thing to recognize is that the National Association of Insurance Commissioners ("NAIC") and insurance regulators' work is always an evolving process. There are two fairly major initiatives under way that may or may not be completed in 2016 but are certainly something to which insurance companies and asset managers of insurance company assets should be paying very close attention.

One of the initiatives is the work being done at the Investment Risk-Based Capital Working Group. This working group has been in existence for about 4 years now and has just passed a fairly major threshold in terms of having a recommendation from the American Academy of Actuaries for updating the bond factors. There will be some fairly material changes, assuming their recommendation is adopted; the intention is to update the current factors used for bonds by using new data on which to base them – current factors are based on data going back to the 70s/80s.

In addition to updating the factors, the recommendation also includes achieving some additional granularity by increasing the number of designations from 6 to as many as 14. This additional granularity smooths out the curve and certainly reduces, if not eliminates, the potential for arbitrage between the NAIC designations.
It is going to have an impact and the working group recognizes that there are a lot of implications from a reporting standpoint and from an asset management standpoint. There is going to be a fair amount of work vetting the recommendation and co-ordinating with other NAIC groups.

The second project is something that is going on at the Statutory Accounting Principles Working Group and that is referred to as the Investment Characteristics Project.
As investment vehicles have evolved, when something relatively new has come up, with some modestly different characteristics, the regulators have done their best to fit it into a particular existing niche.

Unfortunately, what happens is that as all of these little changes accumulate inconsistencies develop, leading to some level of confusion. So the Statutory Accounting Principles Working Group is working on cleaning that up and, quite possibly, that will result in certain kinds of investments being reported in different places. With different reporting; this may well lead to different valuation requirements and risk-based capital factors.

Noel: What major fears and concerns will future regulation of the insurance industry need to address?

Edward: There isn't anything new in terms of fears and concerns for state regulators to highlight. New risks that insurance companies are taking on, that might not be recognized by the current framework are always a concern and are under constant review and oversight at least as far as risks that the regulators are concerned may potentially have a solvency impact.

There is no question that, over the past 34 years, there has been an ongoing drumbeat about increased investment risk, with interest rates being relatively low, that may be driving insurance companies to take on risk in order to enhance their investment yields. This continues to be a focus of state regulators and my group, in particular, does the best it can to stay on top of how risk profiles might be changing. We communicate this in various forms to regulators that are both public and regulator only.

This is an ongoing concern, even if rates do start to rise, and the need for investors to take on risk to enhance yield reduces. The reality is that the investment markets are far more volatile because the world has changed. This means that insurance companies and investment managers will be looking to get into more sophisticated products and strategies; and there is always the concern that you have insurance companies who are adding more risk and particularly that they are adding more risks that they don't understand.

We in the capital market sphere do to our best to monitor that for state regulators. There is no question that the insurance industry, in general, has added risk to its portfolios in the last 34 years; but that has been after a fair amount of derisking as a result of the financial crisis so what we are looking at, so far as the insurance industry as a whole is concerned, are risk levels being back up to where they were pre-crisis.

We will always focus on this and, in particular, situations where insurance companies are taking on more complex products and those that they may not understand. It is rarely a concern for the larger companies because they have fairly sophisticated risk management systems and processes;

but where the concern usually resides is with smaller companies that might not have as sophisticated a risk management system and may be investing in bonds that they really don't understand that well.

Noel: Do you feel that regulators have a role to play in the evolution of products to the market by having clear guidelines on liquidity lock-ups and the nature of complexity of the products?

Edward: That is a fairly complicated answer as the reality is that, at least in the US, you have insurance companies of all different flavours with different kinds of liquidity needs. Whilst it is nice from a regulatory standpoint to have the goal of clear guidelines, having guidelines for something like this is difficult because you are trying to paint a broad brush across companies with a variety of different needs.

Over the past few years there has been additional guidance for insurance departments, financial analysts and examiners, on the liquidity question. The aim is to enable them to focus on those issues with the specific companies and address their liquidity needs on more of an individualized basis. Liquidity is clearly something that is on the table, having gone through what we did during the financial crisis with at least some companies having issues from a liquidity standpoint.

We are always in the process of developing better tools to look at the overall liquidity of portfolios and delivering better information to regulators about how liquid, on a relative basis, portfolios are; but you can never have an absolute measure since there are times when even treasuries aren't that liquid. We are developing better tools and guidance for regulators on making judgements about the relative liquidity of portfolios, and also adding some additional help and guidance for examiners and financial analysts. We have cashflow testing, asset adequacy and Asset Liability Management ("ALM") guidance, so we always aim to help them better understand, when they are looking at an investment portfolio, how to put all of these different things into the proper mix.

Noel: Over 20 states have enacted their version of the ORSA ("Own Risk and Solvency Assessment") regulations. Could we see a migration of domiciling and a weakening of ORSA's intended consequences?

Edward: We are somewhere between 30 - 35 states that have adopted an ORSA law and, subject to modest differences, all of the laws, at least as far as our ORSA specialist was concerned, were essentially the same. There were no material differences and that is important because, the ORSA model was recently made an accreditation standard. That won't be effective until 2018 but, at that point, states will have to be able to say that they have adopted an ORSA law that is subject to minor tweaks in the language, which we do always allow for substantially similar to the ORSA model.

I recognize the concern that you have regulatory arbitrage and companies redomesticating to one state because they think that the regulations are less stringent or more accommodating. In the case of the ORSA they are all the same.

Noel: They are all the same in relation to the rules but the feedback that I have had from insurers is that there is ongoing human interaction between insurers and the regulators at state level and certain states may seem to be 'more friendly' over a period of time. It is quite early on to make a judgement but the question is really looking further down the line and whether insurers are likely to consider past rulings at a state level and decide to set up in one state over another?

Edward: So far we have only been through a pilot project and we have gone live only with those states that have enacted the ORSA laws in 2015. There is a certain education process that needs to evolve amongst state regulators as far as how they look at ORSA and what should be deemed to be an acceptable ORSA is concerned and that is what has been happening.

At this point, and at least for the next year or two in the education process, the NAIC is doing what it can to help state regulators get up to speed on how to deal with an ORSA filing; what is an acceptable ORSA; what kinds of questions they should be focusing on, and where they should be pushing companies to get a more sophisticated analysis going into ORSA. This has been evolving and will continue to evolve over the next couple of years.

It is important to recognize that the concept, not specific to ORSA but in general, about states doing different things is always something that the NAIC and state regulators focus on; and we have a process within the NAIC that really encourages a fairly substantial amount of peer review and oversight. This is most especially visible through what we call the Financial Analysis Working Group and, to use the ORSA as an example, if it comes to the attention of the Financial Analysis Working Group that certain states are being lax as far as their ORSA reviews are concerned, which isn't to say that every state needs to look at the ORSAs in exactly the same way, then they work with the states and tell them to up their game and do a better job.

If it turns out that this suggestion isn't followed then, at its extreme, it becomes an accreditation issue because states have to get their accreditation reviewed and updated every 5 years at a minimum. A state may be required to take corrective action for not doing what they are supposed to be doing regarding the ORSA reviews, particularly when ORSA becomes an accreditation standard.

Noel: Thank you for sharing your thoughts on this topic.

1.2 ROUNDTABLE DEBATE

Operating in the 'new norm' of low rates: how should insurers go about identifying income whilst avoiding overstretch in the search for yield?

Moderator

Bill Limburg
Senior Associate, Patpatia & Associates

Panellists

Rip Reeves
Chief Investment Officer/Treasurer, AEGIS Insurance Services

Anthony Grandolfo
Chief Investment Officer, Validus Holdings

Bill Limburg: Welcome and thank-you to you all for joining me today.

As your firms' portfolios have evolved over the last 12 months, how have you balanced the need to search for yield opportunities in a low rate environment against the certainty of an eventual interest rate hike?

Anthony Grandolfo: We have made some changes in our portfolio over the past 12 months mostly to diversify ourselves across asset classes and to add some more alternative assets to the portfolio, as a lot of the core fixed income markets have become less attractively valued.

We have been anticipating a new cycle of gradually higher rates for quite some time. Maybe somewhat ironically, while we have certainly grown in conviction that we would finally see a rate hike in 2015 our conviction about the path of this rate hiking cycle being extremely gradual has also grown. So looking at things today versus one year ago, we now expect the path to be more gradual - not less - even though here we sit right before the start of a hiking cycle.

This is true of the Fed ("the Fed")and the market as well. If you look back a year ago, at the September 2014 Fed meeting, their own forecast for the expected Fed funds rate by the end of 2015 was 1 3/8 and by the end of 2016 it was 2 7/8. A year later, we now expect at most two rate hikes this year and the Fed is forecasting a year-end 2016 target of 1 5/8, so 125 basis points lower relative to a year ago. That's a fairly big change.

The market is always focusing on the here and now, and yes we are on the cusp of the first Fed rate hike in many years, but the developments of the past 12 months have probably caused us and the market to anticipate a more gentle cycle then we would have thought prior.

Rip Reeves: We have continued to integrate two strategies over the past 12 months. First, we have increased our allocation to real assets such as real estate equity and direct lending on the corporate side, and we are looking into possibly funding mortgage lending. Our internal modelling suggests these asset classes have low correlation to our core fixed income and equity allocations. We have also taken a portion of our high quality fixed income investments and re-categorised them Held-to-Maturity ("HTM").

Both of these moves effectively reduce the overall duration of our portfolio, given they have low interest rate sensitivity for different reasons. On our HTM allocations, it is an accounting tool that effectively removes principal risk of bond valuation with respect to interest rates, particularly effective in a rising rate environment. The real asset allocations also have low interest rate sensitivity, because they are effectively agnostic to stock or bond market fluctuations - barring a credit event.

Bill: Which would you say is a greater concern to you when designing your investment strategies: the anticipation that we will remain in a comparatively low yield environment even as rates rise, or the risk that current asset values will decline if interest rates rise significantly?

Anthony: One is a risk and the other is a paradigm. The greater risk is that rates rise much more rapidly than we or the market expects, and so we get a meaningful unrealised mark-to-market change in our portfolio. That is more of a timing issue, or opportunity cost, as we don't expect permanent losses in capital from that. But you can certainly see major swings in the market value of the portfolio. The key is to make sure you are not significantly mismatched with the duration of your liabilities.

The other side of rates not moving higher and just staying in this long phase of low rates is just a market reality that presumably occurs during a period of time where inflation is relatively low. So, as long as we can migrate away from the current negative real rate environment to something slightly positive, that is ok. For others with very long duration liabilities, it is more of a problem. We'd like higher real rates, but it's not clear the economy can sustain that, so you need to be careful what you wish for.

Everyone has to be careful not to chase a certain yield or income bogie regardless of the market environment. Some portfolio managers think that the longer rates stay low, they risk not hitting their bogie and therefore venture into risks they are normally not comfortable with. You have to work with what the market gives you to a large degree.

Our job is to earn a reasonable rate of return on our investments but primarily we are working to make sure that we support our operating business first and foremost. Where we have excess capital, we want to generate a return that is competitive with other uses of shareholder capital but that is always relative to the market environment that is out there.

Rip: We have been living in a low yield environment for a few years and have generally incorporated strategies to mitigate its income reducing effect on our portfolios. Therefore, I would say rising interest rates are a greater concern currently. Rising rates will be a new factor to consider, especially for bond heavy investment strategies we generally have in insurance portfolios. The idea of principal loss across the bulk of your investments will be a new performance headwind.

Anthony: It is important to note that when we talk about rising rates, it is the risk that rates move beyond what the current yield curve is pricing-in, not so much that they necessarily just "go up". This nuance can often be overlooked.

The market is pricing and anticipating a path of higher rates and it is a path that is much lower than what the Fed is telling us, and that has been the case for several years now. So either the market or the Fed is wrong. Nevertheless we are priced for higher rates so the risk is that rates go up by more than the forward rates implied in today's market. If the current Fed forecast turns out to be right, the market will have to re-price to a higher expected path - that is the risk.

Bill: There are always challenges in predicting how interest rates will evolve and how fast the Federal Reserve and other bodies will adjust those rates. How do you balance the need to be adventurous in maximizing the value that you can extract from your portfolio, while also being cautious that you are not caught on the wrong side of an interest rate assumption?

Anthony: Regardless of the environment that we are in, we define our risk appetite in terms of the required liquidity that we need to operate our business and our tolerance for drawdown risk relative to our liability exposures and excess capital. Whether we are slightly more or less adventurous on the investing side is going to be more a function of our capital position, the risks we take on the underwriting side, along with relative value opportunities on the asset side, rather than just because yields are low.

We try to define our risk tolerances first and then where we have excess capital and liquidity is where we can be a bit more return seeking. It is always difficult trying to time markets. At the end of the day we are trying to make sound relative value decisions to the extent that we have our liquidity and capital needs satisfied. If it takes us some time to be right we can afford to be patient.

Rip: I agree with Anthony this exercise/process is important, given investments into newer alternative classes – which is a catch phrase for a broad spectrum of strategies. We have increased the amount of stress testing we do in our internal, and external, asset allocation modelling. Specifically, we look at numerous stress scenarios; and recent events have oddly been helpful in defining stress scenarios. For example, the 2008 financial crisis defines particularly high levels of volatility and correlation. We run investment options to efficient frontiers based on various stressed assumptions in our attempt to model when the strategies break down. It will be interesting to incorporate this year's 3rd quarter experience into our modelling assumptions, when we again observed high levels of volatility and correlation.

We find stress testing helpful in highlighting the "left tail" characteristics of investment opportunities in our development of a diversified strategy.

All of our modelling does not take the place of judgement. The one thing we know for sure is that the model is probably wrong! At the end of the day, after digesting all the data and resources, we have to make decisions. Further complicating this process is that we shouldn't develop investment strategy in a vacuum. We also incorporate our company's enterprise objectives and risk appetite in our investment decision making process.

Bill: You have both indicated that you have been incorporating certain portfolio diversifiers (e.g. high yield, real estate, equities, etc.) in the low rate environment. How do you assess how "alternative" you want to be in your investment strategies? That is, on the spectrum that ranges from purely fixed income diversifiers to more non- traditional and capital appreciation-oriented assets, how adventurous do you feel that you can be?

Anthony: We are always trying to find the mix of assets that can allow us to generate the highest return per amount of risk that we feel is appropriate. Within this we want to find assets that are less correlated with others and have a high risk premium priced into them, but of course need to be very mindful of liquidity needs.

Some of those assets you mentioned can be good portfolio diversifiers, like real estate and equity. How we size it is tricky because relative value relationships can change more quickly than you can necessarily re allocate investments, particularly within the alternative area where you may be locked into illiquid assets for a period of time.

To the extent that we feel that we have our required liquidity and downside tail value risk modelled appropriately we are comfortable venturing out into the alternative space.

One of the things that makes it more appealing in today's environment is that some of the traditional core fixed income products in today's tight spread, ultra-low yield environment may in fact be more risky then some of the alternative investments that historically have been considered higher risk. So compare a 10 year triple-B corporate bond, which is probably the most popular asset class within the insurance industry. Given the interest rate and spread duration of that in today's environment, it may be a higher risk asset then a double-B floating rate senior secured bank loan. The liquidity advantage one used to get from the public fixed income markets is no longer so great anyway.

So, you always have to view the desire for "non-traditional" assets within the context of what the different markets are pricing in at any given point in time.

Rip: Our starting point is our investment risk budget, which is an output from our Internal Capital Model. Together, with the AEGIS executive team, we decide on our annual risk budget. Then we are charged with how we are going to spend it, knowing we don't have to spend it. Given we have reduced accounting and economic risks in our investment portfolio, we have some "dry gun powder" in our risk budget – should we find investment opportunities we feel are suitable. The alternative sector offers a wide range of investment types, and one of the disadvantages is a lock-up period. Given one of our primary objectives of our insurance investments is to provide liquidity to pay claims, a thorough understanding of our investment liquidity – relative to forecasted required liquidity – is essential. We have a process in place to monitor investment liquidity and forecasted liquidity needs regularly, given our increased allocations to alternative investments. We believe risk budget and liquidity monitoring are key processes as we increase allocations in this sector.

Bill: Where are you expanding your risk budget today to step beyond where you may have been in the past?

Rip: When we think about where we can "spend risk", we tend to look at duration, credit, leverage and liquidity risks to potentially trade for higher levels of income and expected total return. From a duration risk standpoint, it's not good timing to extend out the yield curve given impending rising rates. I'd offer much of the Property and Casualty ("P&C") insurance world has been going the opposite direction to shorten duration, thus reducing our exposure to rising interest rates.

Regarding credit risk, I think many of us have executed the "down in credit trade" as far as we feel is suitable for our portfolios and enterprise. Given the low yield environment, this trade has been popular over the past several years.

The use of leverage – possibly in securities lending – hasn't been particularly attractive due to our low yield environment. There are alternative strategies that use leverage to increase potential yield and return, however that certainly increases the risk of those mandates and is challenging to measure.

One of the risk levers many P&C insurers have been relatively slow to take advantage of is liquidity risk. Like Anthony, we have large allocations to high grade fixed income investments. Therefore, we have high levels of investment liquidity relative to our forecasted enterprise liquidity needs. Investing in the alternative space, where you are frequently locking up liquidity for a period of time, is new for P&C insurers – especially compared to the pension, foundation and endowment sectors. Many of the alternative sectors offer attractive income and total return opportunities for us – especially given our generally high levels of excess liquidity.

Anthony: In today's environment where public fixed income markets are far less illiquid then they ever have been and yet you are not really getting a higher-than-average risk premium in compensation for that, where you do have excess liquidity it does make sense to migrate to sectors where you actually can get paid for that risk.

For portions of our portfolio where we have been adding on the private debt and direct lending side, we like certain floating rate assets in today's environment where short term rates will inevitably migrate higher over the next few years. We also think that for a measured portion of our portfolio private equity still has a role if you are with the right managers, given that public market valuations have gotten a bit stretched.

These are areas that we still like but the overarching theme would be that we are in an environment where there aren't a lot of cheap assets out there. This will change at some point as volatility is certainly on the rise. There will be some people with very specific skill sets in the oil and gas space or emerging market space who will be able to pick through some of the wreckage occurring there, but that is not really where we are focused.

We are very mindful of the fact that we are in an environment where there is really not a lot of compensation for risk. Therefore we need to be as diversified as we can within asset classes that have less correlation to the broader public markets and offer some risk premium that we are not getting in some of the more traditional products.

Bill: Thank you both for sharing your views on this topic.

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SECTION 2

RISK MANAGEMENT

2.1 INTERVIEW

How should insurers select and treat less liquid assets in an ORSA-driven internal modelling framework?

2.1 INTERVIEW

How should insurers select and treat less liquid assets in an ORSA-driven internal modelling framework?

Interviewer

Sarah Mortimer
Account Director, Rein4ce

Interviewee

Prateek Chhabra
Vice President - Risk and Exposure Management, The Hanover Insurance Company

Sarah Mortimer: Thank-you for joining me today Prateek.

Can you begin please by giving us some background on your role at The Hanover Insurance Company?

Prateek Chhabra: My primary responsibilities are managing the Enterprise Risk Management ("ERM") process, framework and governance. I spend most of my time on underwriting risk related to property and liabilities lines, especially from a catastrophe risk perspective. I also provide oversight on our investment, counterparty, emerging and operational risks.

Sarah: Do you currently allocate to illiquid assets? If so, why?

Prateek: We target assets based on our appetite for different investment categories, risk and return relationship, income targets and risk diversification, etc. We do ensure that, at any given time, illiquid assets in our portfolio don't exceed a specific percentage of the total portfolio under normal and stressed circumstances.

Illiquid assets can be of many types: bespoke or complex assets that have a limited secondary market, securities related to industries or names that don't generally have a lot of liquidity in the market, certain complex hedges or instruments that have a limited liquidity in the secondary market, etc.

Another category that needs active monitoring is debt instruments that, under normal circumstances, are liquid but because of the stress on the issuer, industry or economy, the liquidity associated with them dries up. We keep an eye on such developments to make sure that we don't exceed our thresholds of illiquid assets under different circumstances and scenarios.

Sarah: Can you tell us what the threshold is or is it on a case-by-case basis?

Prateek: Thresholds are on case by case basis and can be soft thresholds or hard limits based on a company's risk tolerance and investment strategy. Liquidity thresholds are generally based on possible liquidity needs under stressed scenarios as well as appetite for risk from alternative investments. I believe that thresholds should be based on normal circumstances as well as stressed scenarios. Different types of illiquid assets behave differently in stressed circumstances, so it becomes important to set thresholds accordingly.

Sarah: Why is there a necessity, either now or in the future, to include less liquid assets in a portfolio and what do you see as being their role in an overall investment plan?

Prateek: Interest rates are low so the investment returns of relatively conservative asset portfolios of insurance companies have been declining. Some companies are reaching for yield while others have always included such assets in their asset allocation mix to boost the returns and diversify risk. Some of these alternatives assets offer better RISK-RETURN relationships and better diversification for the portfolio, but are illiquid because there is no established secondary market. Good understanding of appetite for liquidity risk helps insurance companies tap into these illiquid assets while managing the downside.

Sarah: Does including less liquid assets in a portfolio negatively or positively affect the overall performance of the investment plan?

Prateek: The investment objective is to generate better investment returns over the long term while keeping the risk within the tolerance levels. If an asset is identified that has better risk-return relationship, helps improve returns, is within the investment risk appetite, helps diversify the portfolio but the limitation is that it is illiquid, the investment decision becomes a factor of how much capacity you have for illiquid assets. So, yes, including less liquid assets in a portfolio can positively impact the performance of the investment plan if the liquidity risk is managed within the tolerance levels.

Sarah: What challenges have you faced in modelling illiquid assets into your internal modelling framework, given the nature of the commercial and personal insurance risks you're exposed to?

Prateek: Modelling illiquid assets is difficult and the main reason why they are illiquid is because they are either complex instruments or private in nature, secondary market for them is limited, there is absence of observable market price and they are not easily modelled using standard systems. Special treatment is needed when modelling and pricing these assets. Property and Casualty ("P&C")

companies usually have a conservative portfolio, so the appetite for such securities is smaller.

We do have certain investments in our portfolio for which we have built special models in-house for risk analysis and pricing and keep an active eye on their value against the expected returns. For others, we depend on pricing from the fund sponsors and, in almost every case, if we accept the pricing from the sponsors on these instruments, we make sure their process is audited and reviewed by independent sources. Along with this, we periodically validate these valuations or pricing using third-party independent analyses.

Sarah: Do you have any examples of modelling challenges that you have had with certain assets classes?

Prateek: Certain alternative investments that we invest in through different fund sponsors are fairly challenging to model. These kinds of securities are being used more widely by life insurance companies, as well as P&C, as they can help to manage portfolio durations - you can change the terms, as per the durations that you are looking for.

These kinds of instruments have sponsor-based pricing, but at times there is enough information and incentive to create internal models. The investment division in an insurance company is usually not a very large group. For investments like these you have to decide between investing in resources to build the models in-house and validate the sponsor pricing on a regular basis versus accepting the sponsor pricing. For example, with real estate recovery, you may not be fully convinced that it is on a fixed trajectory that won't materially change - so to keep a close eye on it there is value in having the models in-house. However, the resources that this needs may or may not justify the benefit you get from it as you do get sponsor pricing especially if your portfolio of such securities is relatively small.

If you do elect to build these models internally, then there is a risk that you will try to over-use them in an effort to generate more value and grow the exposure towards securities that normally you wouldn't consider because it takes time and effort. You need to manage it based on your risk appetite and investment strategy and not let skill sets and capabilities drive investment decisions.

Sarah: Under what scenarios would you use third-party analysis?

Prateek: In almost all scenarios we use third-party companies to conduct the risk analysis for these investments and, in some cases, we ask for valuations as well. These risk analyses and valuations can be based on existing models, proxies, or bespoke models that may need to be built. We try to get second opinion on almost everything.

Sarah: Specialist managers are creating ORSA-friendly versions of their hedge funds and private equity funds. How have you received this trend and what further developments are required to make illiquid assets more appetizing?

Prateek: As far as certain funds being ORSA-friendly is concerned, that is not what should drive a company's investment strategy.

The investment portfolio should be based on how much volatility you are willing to take, diversification you need, duration you are targeting, asset liability matching that you aim for, and how much risk you want to pick up from the investment side. This is considering that you have risk on the liability side of the balance sheet as well. Based on all of these risk factors, the important questions to answer become - what kind of liquidity you need as a company under normal, as well as, stressed circumstances? What eventualities could make our asset portfolio get stressed? And are you prepared to handle those situations, based on your investment strategy and portfolio? These are issues that should guide the investment decision.

For ORSA reporting, if an investment decision makes sense for your company from a risk perspective, you should be able to explain really well 'why' it makes sense in your risk report. It shouldn't be the other way around where 'ORSA friendliness' guides the investment decision.

Sarah: Do you feel that there are further developments that can be made to make illiquid assets more appetizing?

Prateek: If we have more independent third parties doing better valuations and risk assessments of these instruments, we don't have to be dependent on certain third-party service providers or the sponsors for pricing and we would feel better about the valuations. Developing a secondary market for these illiquid assets would also help take off some of the pressure from asset managers' minds, as they can provide risk management options.

Sarah: Is there anything that you would like to add on the topic?

Prateek: ORSA-driven internal modelling should not drive investment strategies. Your risk management should drive the investment strategies and, if you are managing your risks appropriately, it is automatically going to come out in your ORSA model.

Sarah: Thank you for sharing your thoughts on this topic.

SECTION 3

ASSET ALLOCATION

3.1 WHITE PAPER

Asset allocation for insurers in an era of tightening regulation

3.2 WHITE PAPER

What's holding back allocations to private debt and is this the uncrowded opportunity yet to be discovered?

3.1 WHITE PAPER

Asset allocation for insurers in an era of tightening regulation

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Tim Antonelli, CFA
Regulatory and Capital Strategist, Wellington Management Company LLP

In recent years, the Insurance Group at Wellington Management has seen a growing number of insurers express an interest in undertaking a strategic Asset Allocation ("AA") study. The low-yield environment of the past few years, along with the core fixed income-centric nature of insurance portfolios and a widely anticipated eventual rise in interest rates, all seem to be contributing to this surge in interest. Another key driver of interest in AA studies is the global trend toward increasingly rigorous regulation of insurers. Prominent examples include the NAIC's Own Risk & Solvency Assessment ("ORSA") and changes to its SVO risk-based capital model in the United States, as well as implementation of the Solvency II regulatory regime in the European Union.

Asset allocation study: definition, process, goals

Before delving into the impact of regulatory shifts on insurers' asset allocation, some context on the strategic asset allocation process itself is in order. We define this process as a method for creating an asset mix that aims to strike an appropriate balance between expected risks (both business and investment) and return over a long-term investment time horizon.

In our view, the appropriate AA philosophy for insurers is simple: An organization's investment strategy must fit with its core business. This is a crucial point as insurers consider their total-enterprise risk exposures. We believe that a well-constructed investment strategy that dynamically adapts to the insurer's specific circumstances as these evolve should confer competitive advantage over time.

Steps in conducting an asset allocation study for an insurer

- Review capital requirements/planning
- Review overall investment goals/objectives
- Determine impact/sensitivity to statutory surplus/ liquidity changes on investment goals
- Determine investable universe
- Consider asset class and "risk assets" limits (i.e., reserve versus surplus assets)
- Review industry/peer data
- Consider investment-management constraints (e.g., gain/loss, social screens)
- Perform portfolio analysis — risk/reward (mean variance type)
- Review functional regimes assessment (e.g., growth, inflation, deflation)
- Assess liquidity, volatility, income, and return expectations
- Perform stress tests (e.g., impact of a catastrophic event on surplus and liquidity)
- Consider implementation issues:
  - Overall portfolio structure (number of managers, number of accounts/ companies, active versus passive)
  - Manager selection
  - RBC impact
  - Fee impact
  - Adding new managers versus expanding existing role (e.g., moving from core to core plus)
  - Tax impact
  - Turnover costs
  - Frequency of asset allocation projects moving forward
  - Potential investment-policy changes

Re-risking to achieve income and liability-matching targets

In an environment of historically low interest rates, insurers have had to get creative with their investment strategies to achieve meaningful returns. Rerisking has been a common response to this challenge, particularly among US property-and-casualty and health insurers, and implemented through an increasingly diverse array of investment strategies. For the remainder of this paper, we use Property and Casualty ("P&C") insurers as a proxy for the overall US insurance industry except where otherwise noted.

P&C insurers' allocation to "risk assets" (defined as high-yield bonds, common and preferred stock, and other invested assets) has climbed each year since the financial crisis, to 27.5% at the end of 2014. While unaffiliated invested assets grew 3% year over year, to US$1.36 trillion — the sixth straight year of growth — generating meaningful yields from those assets again proved problematic. The industry's weighted-average net investment yield was only 3.68%. This was up slightly from 2013's 3.43%, but was still the second-lowest number since 2002, when industry data first became available.

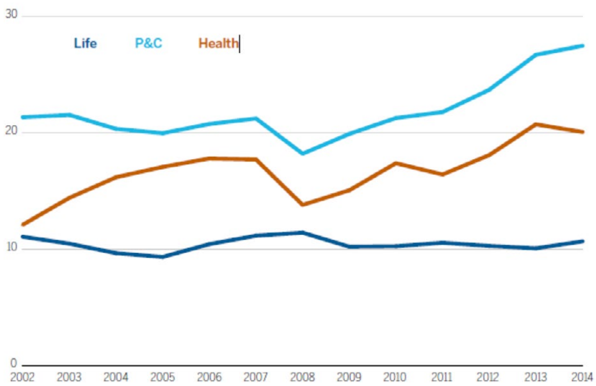
Key US and global industry themes

US themes
- Searching for yield
- Diversifying from investment-grade fixed income
- Increasing interest in alternative assets (private equity, real estate, hedge funds)
- Executing asset allocation studies
- Seeking non-US exposures
- Diversifying fixed income exposure (adding bank loans, high-yield corporates, non-agency MBS)
- Researching Contingent Convertibles ("CoCos")
- Continuing interest in dividend equities and high-active-risk equity strategies

Global themes
- Searching for yield
- Diversifying from home-country exposures (currency, credit, etc.)
- Increasing interest in alternative asset classes
- Adding to illiquid investments
- Growing impact of regulations on investment strategies

Although equity and bond markets have been choppy in 2015, they posted solid gains in 2014: The S&P 500 was up 13.7% and the Barclays Aggregate climbed 6.0%. Insurers attempted to capitalize by adding marginally to their allocations of high-yield credit, common stock, and other invested assets, including hedge funds, though retaining substantial allocations to investment-grade fixed income in their quest for income. As a result, allocations to risk assets rose to the highest share of P&C insurers' total invested assets since industry data became available in 2002. Of note, post-crisis reriskinq has been more pronounced among P&C insurers than their health and life counterparts (**Figure 1**). Risk assets as a percentage of P&C insurer surplus accounts rose to 54.5%, the second-highest level since 2002.

Figure 1 - Total insurance industry: Risk assets as a percent of unaffiliated investments



Source: SNL Financial

Other invested assets

In addition to taking on more corporate credit and structured product risk in their bond portfolios, insurers once again bumped up their allocation to other invested assets. This category is made up of assets that don't fit neatly into the categories of fixed income, common or preferred stock, and real estate/mortgage loans. Private equity and hedge funds make up a considerable portion of the "other invested assets" classification. In total, other invested assets as a percentage of unaffiliated investments rose slightly to 4.5% from 4.4% in 2013. However, the gross yield from such investments declined to 6.85% from 7.33% in the prior year.

In aggregate, investments classified as private equity or hedge funds in statutory financials increased 2.9% during 2014, a figure that netted a 13.7% gain in hedge fund investments against a 4.6% drop in private equity holdings (**Figure 2**). The strategies with the most asset growth during the year were all hedge fund approaches: long/short (US$665 million), multistrategy (US$498 million), and emerging market (US$69 million). Hedge funds' share of the industry's total invested assets has never been higher.

Figure 2 - P&C insurance industry: Hedge funds and private equity as a percent of invested assets

Source: SNL Financial

With risk assets now comprising a significant part of invested assets, managing the associated downside risk has never been more vital. A host of potential solutions are gaining traction in the P&C industry today, ranging from hedged equity programs to the outsourcing of high-yield credit approaches to experienced specialty managers.

Global developments

While US-based insurers have focused on taking greater risk in the face of low interest rates, European insurers are wrestling with the pending capital charges they will face on higher-risk assets under the European Union's new Solvency II regime.

Effective in 2016, Solvency II will impose more onerous capital charges on common stock (ranging from 39% to 49%

depending on country of issue), high-yield bonds (spread risk of 4.5% to 63.5% depending on a security's rating and duration), and hedge funds (49%). This is in contrast to much less severe Risk-Based Capital charges for US non-life insurers (**Figure 3**).

Figure 3 - Selective comparison of US Risk-Based Capital to Europe's Solvency II

	US Risk-Based Capital	Europe Solvency II
High-yield bonds[1]		
5-year BB rated	2.0%	22.5%
5-year B rated	4.5	37.5
20-year B rated	4.5	63.5
Common Stock[2]	15.0%	39.0 - 49.0%
Alternatives		
Hedge funds	20.0	49.0
Private Equity	20.0	39.0

1 Solvency II charges reflect spread-risk component only
2 Solvency II common stock capital charges are determined by country of issuance
Sources: NAIC, EIOPA

At this point, it is unclear what impact the implementation of relatively strict Solvency II rules may have on US insurers and their future allocations to risk assets. The effect of the difference in regimes on issuance of high-yield debt and the viability of alternative asset classes will be an interesting story to follow.

Looking ahead

Even as US P&C insurance companies have meaningfully ramped up their investment risk, regulators around the world have meaningfully ramped up their demands. New global regulatory requirements under the ORSA and Solvency II regimes, as well as proposed regulation such as international Risk-Based Capital standards from the NAIC, place more responsibility on insurers to understand and manage their investment risk. Amid all the new and proposed regulation, one central element is consistent: No longer should an insurer's investment activities be walled off from its Enterprise Risk Management ("ERM"). Regulators across multiple jurisdictions are encouraging insurers to adopt holistic risk-monitoring frameworks that integrate risks of all types: investment, business, operational, counterparty, and others.

> "No longer should an insurer's investment activities be walled off from its Enterprise Risk Management ("ERM")"

Our recommendations

Tools and resources are available to help insurers assess their investment risk in the context of this evolving regulatory environment.

- Asset allocation reviews can help an insurer develop customized investment strategies and build portfolios around anticipated liability streams; make financial projections based on various potential asset mixes; and stress-test those mixes for their impact on capital and earnings.
- Fixed income investments still make up the bulk of insurers' investment portfolios. Liquidity in secondary bond markets — particularly credit sectors — has become increasingly constrained as stricter post- crisis regulation has caused banks to reduce their market-making role. This trend makes the management of liquidity risk a vital task for bond investors of all stripes. Information systems that harness new technology to assess portfolio liquidity across a variety of liquidation timetables and market conditions, such as our firm's Liquidity Evaluation Framework ("LiEF"®) system, can be valuable tools in managing this risk.
- Increasing merger and acquisition activity and rising issuer leverage accentuate the need for fundamental research in managing credit mandates, both investment grade and high yield. Such mandates could emphasize income in pursuit of total return, and mitigate downgrades/defaults through comprehensive research and diversification.

The information contained herein reflects the views of the authors. Views are subject to change without notice and do not represent a "firm view." Any recommendations presented in this article may differ from positions held in portfolios managed by Wellington Management Company LLP or its affiliates. Information provided is not to be considered investment advice or a recommendation to buy or sell any security. Alternative investments tend to use leverage which can serve to magnify potential losses. Additionally, they can be subject to increased volatility, counterparty risk and illiquidity, among other risks.

What's holding back allocations to private debt and is this the uncrowded opportunity yet to be discovered?

Robert Absey
Senior Managing Director,
Global Head - Insurance
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Why should insurers allocate to Private Debt?

For some time now, insurers have considered the prolonged low to negative yield environment to be the greatest investment risk to their asset portfolios, resulting in increased interest in higher yielding, and potentially riskier asset classes to help bolster returns. One of the ways in which this can be achieved is through increased allocations to less liquid asset classes including private debt/credit. Credit disintermediation – with the providers of credit (traditionally banks, but now more non-bank lenders like insurance companies) moving closer to borrowers, is a well advanced trend in the US and is now spreading to new end markets and to other parts of the world. As this secular trend gains momentum, it opens up a new set of attractive investment choices to insurance companies and other long term private investors. Private credit - in contrast to public credit, has several key characteristics that make such strategies well suited for insurance company asset portfolios. They provide a solid defense against rising interest rates (which may not be a current concern, but certainly a concern nonetheless) because of their low correlation to changes in government bond yields. They carry underlying illiquidity premiums that investors can capture if they are willing to lock up capital and take a long term view, and given their liability structure, insurers are well positioned to hold these assets long term. Private credit assets provide attractive risk-adjusted returns as they typically offer higher yields than more liquid traditional bonds without adding credit risk, and have better downside protection (due to better covenants), and low correlations to many core fixed income holdings typically found within insurance portfolios.

What are the different categories of private debt and how can an insurer assess their eligibility for each one?

The broader allocation framework that we see emerging – what we've identified as four main pillars of private debt/credit investing, includes direct lending strategies in large end markets in commercial real estate, residential mortgages, middle-market corporations, and infrastructure projects. We consider all of these pillars a great choice for insurers – all well-suited for addressing their current needs. Most provide for a good Asset Liability Management ("ALM") match via long duration and/or predicable cash flows; they provide yield enhancement via capturing the illiquidity premium and overall attractive risk adjusted returns, potentially solid and very favorable capital treatment via good diversification and/or capturing the matching adjustment, plus favorable accounting treatment via less exposure to mark-to-market. While specific appetites for these investments can vary from insurer to insurer depending upon the specific liability profiles, risk tolerance, capital levels, business line, and other issues idiosyncratic to the insurer, private debt/credit investment strategies remains a very attractive option overall.

> "P&C, health and global re-insurers whose liabilities may be shorter in nature, or whose liquidity/cash needs may be higher, will also find illiquid private credit strategies attractive"

Does the illiquidity lock-up of private debt mean for some insurers the asset class is unsuitable?

Not really. Life insurance companies are natural providers of liquidity given the long tail nature of their liabilities, and as a result are more than willing to give up some liquidity and allocate to attractive less liquid sectors of the market – like private debt/credit, in order to capture any incremental return achievable via the illiquidity premium. That said, we are finding that other types of insurance companies – P&C, health and global re-insurers whose liabilities may be shorter in nature, or whose liquidity/cash needs may be higher, will also find illiquid private credit strategies attractive. Since the benefits are the same and remain compelling, these companies are allocating to these strategies at the expense of public bonds whose relative risk adjusted valuations are less attractive. With low persistent interest rates, declining book yields, and reduced investment income, insurers are finding that they may have just a little more liquidity than they actually need.

Multi-sector fixed income is growing in popularity for insurers seeking diversification and exposure to uncorrelated risk premia. What equivalent style structures are there in the private debt sector?

As alluded to earlier, the increasing role of alternative credit providers, like insurers, has essentially created a new set of investment opportunities, just as the earlier disintermediation of banks by capital markets created new asset classes. We believe that this trend will continue and we're starting to see a convergence between traditional fixed income and alternative investments (like directly originated private debt/credit) essentially expanding the traditional fixed income asset allocation framework. This broader allocation – by virtue of diverse exposure to different sectors, types of borrowers, and varying regions (the four pillars) – maximizes the opportunity set and results in a less liquid investment profile but one that achieves a higher risk-adjusted return potential and more diversification - all goals of multi-sector fixed income investing.

How can insurers best position themselves in private debt for rising rates?

Insurers, rightly so, should be concerned about the specter for inflation and the potential for rising rates – particularly quickly rising rates. An increase in interest rates is often accompanied by healthy real economic growth and rising inflation and inflation expectations. Because infrastructure debt investments are backed by real physical assets and have cash flows often linked to LIBOR based indices (correlated with changes in inflation) they are naturally linked to inflation and can provide an effective inflation hedge in a rising interest rate environment. Similarly, direct loans made to commercial real estate are typically floating rate, which can provide natural rising investment returns as interest rates increase.

"we're starting to see a convergence between traditional fixed income and alternative investments"

SECTION 4

INVESTMENT OPERATIONS

4.1 EXPERT DEBATE

Weighing up internal oversight and control compared to outsourcing to an external provider – what should be in and what should be sent out?

4.1 EXPERT DEBATE

Weighing up internal oversight and control compared to outsourcing to an external provider – what should be in and what should be sent out?

Moderator

Noel Hillmann
Managing Director, Clear Path Analysis

Panellists

Krishnan Ethirajan
Chief Operations Officer, IronServe, Ironshore Insurance

Shawn L. Sylvester
Senior Vice President, Global Business Services, Endurance

Paul Fahey
Senior Vice President, Relationship Management, Northern Trust

Noel Hillmann: What are your aims for outsourcing and what areas have you chosen to keep in-house versus outsource? How did you arrive at this decision?

Shawn L. Sylvester: Outsourcing, although executed at a tactical level, must be part of a larger strategic objective. The drivers for outsourcing must be easily understood. The days of outsourcing just for labor arbitrage are no longer as attractive as they used to be as global cost have started to equalize. The additional cost of oversight or middle office to monitor an outsourced arrangement is not as attractive. The potential processing risk or quality concerns are no longer easily outweighed by the savings benefit. The decision and structure must show an economic benefit but must also align with a corporate strategy.

A company that has a steady product mix and premium volume can look to leverage an approach that is much more focused on stable operating processes as well as squeezing out as much economic benefit as possible. A company, like Endurance, that is rapidly growing, expanding its product mix and fully engaged in merger and acquisition activities must focus any outsourcing on meeting those changing needs. Looking for specific resources to target short and long term needs creates a challenge for both the supplier of services and the carrier. The control environment is key to ensuring proper service delivery. This should include security, resources sustainability and retention, operating controls, agreed Service Level Agreements ("SLA") as well as contract terms that create a partnership approach rather than an adversarial relationship.

Krishnan Ethirajan: We are a relatively young company, less than 10 years old. We started post-hurricane Katrina as a speciality property and casualty insurer out of Bermuda and over the past 7-8 years we have grown to $2.5bn dollars in gross written premium; from an operational perspective that kind of growth comes with significant challenges in terms of supporting our platform across Bermuda, the US, London and the rest of the international markets. We took a strategic look at how do we best build an operational platform that enables us to scale efficiently whilst managing our expenses.

Our key differentiator is our expertise in specialty underwriting and our ability to look at unique risks and manage them effectively. With that kind of a bespoke and specialized underwriting capability, we still believe our operations should be standardized, scalable and support the business in an efficient manner that gets us the best expense advantage. We wanted to do this early in our cycle as we grew our company; so 4 years ago we looked at building a shared services structure which was initially focused on the US platform for Underwriting and Claims Operations. As we started to grow the international business significantly, we wanted to pull everything together in a shared environment that will allow us to outsource non-judgemental transactional functions.

We have outsourced everything that does not involve any significant decision-making. We outsource our underwriting and claims operations, actuarial and risk management, IT, finance, etc. and it allows us a good base of everything that is not unique from a company perspective and focus in on the areas that are core to our business.

Noel: Paul, what is it you find to be the main reason for outsourcing and what are the key areas that most of your clients keep in-house, as opposed to outsourcing to companies such as yourselves?

Paul Fahey: Krishnan's last comment on everything that is not unique to Ironshore would be functions to outsource: this is the key. If there is something specific to a particular entity, then that clearly is more difficult to outsource to a service provider because of questions around their ability to support it. Also, from a control perspective, that willingness to give up something that is unique to their process is a difficult challenge for clients.

Outsourcers are getting better at dealing with unique processes, in part because there is a growing confidence that we are dealing with many entities; so we have generated a 'wisdom of the crowd' way of thinking and are now a lot better at leveraging that for the support of all of our clients. When we look at a particular process that is outsource-able, we look at it, review it, and offer back to the entity that is looking to outsource a certain level of expertise - not simply replicating what they do in-house in our shop. If it ever gets to a point where it is simply 'their mess for less' then that is not an effective outsourcing relationship. It does focus on those things that are generally available to the marketplace and things that are not specific to the insurance entity itself.

Noel: Do you find that many clients overreact to market and business changes and make the choice to outsource at that time, or do you find that they plan in advance and make changes before the need is really there?

Paul: It is a bit of both. Those who do it well, even if they have not planned it, have done the due diligence process and the act of outsourcing itself requires a significant amount of planning.

When we look at outsourcing itself, done properly, there is a significant amount of work upfront. We often refer to it as a marriage and so the courting process is very important in all of this. These outsourcing processes are often structured, contractually, as a 7-10 year relationship - so longer term than your typical term of outsourcing of smaller operations; and the divorce is messy should it come to that.

The relationship needs to be one that, beyond there just being a functional model that the outsourcer can provide, there is a cultural fit between the two organizations; after all, they are going to spend a lot of time together.

Done right, that sets up the long term relationship for success; but, done poorly, it becomes a difficult process from day one and really it is very difficult, if at all possible, to recover from that.

Noel: How should the risk of failure be appropriately managed for outsourcing to an external partner and what type of periodic reviews is necessary for a harmonious and productive relationship?

Shawn: Establishing clear mutual expectations on each side of the relationship, in detail, is vital in starting the relationship off properly, as management and support change hand overs must be transparent as to maintain continuity in the understanding of what should be delivered. If at all possible providing terms that put "skin in the game" by the supplier are helpful, but also providing incentives and penalties for a lack of delivery help in clarifying expectations. The initial agreement should not be done at the expense of speed as the payback for proper planning, risk assessment and expectation setting will be yield returns once the process is operating effectively.

Krishnan: It is very important to have a strategic view of what you are looking to outsource and how you are going to manage, not just the transaction but the overall relationship moving forward. In our case, it was essential that we looked at a holistic view of how we wanted to scale our operations as we grow. We also wanted to build a structured governance process, where we could manage the relationship at arm's length, but also have significant visibility into how the functions are being delivered back to us. The process involves having deep relationships at an operational level to the counterparts who are delivering those services back to us, as well as various stakeholders within the outsource provider.

We also structured an environment that was built more as a virtual captive where we retain some level of control as to how the operations are being delivered. This is partly because, as a company, we do a lot of unique things in a bespoke manner, as opposed to other outsource transactions which primarily do transactional stuff which do have a lot of scale where they are doing same things and have 50-100 people doing the same functions. We have unique sets of processes which are not standardized across the board so it was essential for us to have some visibility on a day-to-day basis, manage and train the staff performing the work, get them involved in understanding our business and, on an ongoing review basis, to have appropriate controls over how we manage those relationships.

At a high level we have weekly, monthly and quarterly meetings to talk about strategic aspects of our transactions and the relationships. Beyond this, our longer-term view of how we want to structure the arrangement was not necessarily to perform our 'mess for less' but, over time, to focus on a broad, standardized set of processes across the globe. We are evolving from a focus on expense on labour arbitrage to more of a service-on-demand type of model - significant projects were kicked off as part of an initiative to transform the way that we did our business globally. This allows us, over time, to get to a point where we can look at this in a more commoditized manner as opposed to the way we manage it today.

Initially, we wanted to get some of our structural delivery models in place, while we started looking at how, even in our core operations underwriting processes and other areas, we were making decisions to make it much more of a self- service, using a broad array of technology as well as work flow and standardized processes. The governance has evolved over time to make our focus less day-to-day in certain areas and more strategic in aspects of the transformations and standardization.

Paul: I couldn't agree more with Krishnan's point on a structured governance approach as it is certainly key – and, with that, comes a number of things. One of the interesting aspects of outsourcing is the oversight model and often, with an internal model being outsourced, we see more of a remnant of the internal team overseeing the outsource provider; and by its very nature an internal team is a tough audience as they were previously doing the job. Human nature being what it is, the success of the outsource provider often depends on the in-house team previously charged with that role and there is a winning-over that is required.

The key to this is that the outsource provider has to be seen as an extension of the insurer and/or asset manager. The outsourcer needs to be part of the strategic planning process so, when you look at it, you see the outsourcer as part of your organization. The due diligence process is an interview process, not just about finding the best provider, since you need to look across the table at the team that will be providing the outsourcing needs and ask yourself whether you would hire these people into your organization. That is how tight the relationship with the outsource provider is.

Key performance indicators are certainly an important part of an outsourced relationship. The reason for the Key Performance Indicators ("KPIs") is to manage the expectations, roles and responsibilities of both organizations and to hold everyone accountable for their part in the success of the enterprise. They cannot be simply a stick to beat the outsourcer with and, if it is done this way, there is no mutual responsibility for the success. Again, you don't ever get away from the fact that there is a provider and a client but the two are so tightly bound together that it is about holding each other accountable for success.

One of the things Krishnan mentioned is that the relationship does evolve. The governance structure and KPIs that are put in place on day one are not necessarily the same tools and structure that are effective 6-9 months later; both entities need to understand this, and approach it in that way, to ensure that the model that is in place today is for the success of the ongoing business.

Noel: Shawn, how much do you feel it is your job, as the client, to lead the outsourcers in what you are expecting of them and in further developments that you want them to make in terms of services? How much do you feel it is the administrator's role to be looking at changes that you need to make to the relationship and to the services being given on an ongoing basis?

Shawn: Well, I guess the correct answer should be that it is a partnership. The reality is as a business owner I feel it is my responsibility not only to the business but my shareholders to be responsible for the development of the process, relationship and controls as well as ongoing improvements. What I look for is that same attitude from the service provider. If they talk in terms of ownership and responsibility I know they have my best interest and the success of the company in mind. When I start feeling like it is a relationship where I am being charged for every little item or the billing has to be explained I feel that is an indicator to be cautious.

Also on the service delivery side, I take a vested interest in the quality, caliber and commitment of the outsourcing partner's staff. It is a way to extend the level of commitment to our organizational needs and not just the providers. This dynamic helps to open up dialogue and create a feeling of transparency and trust.

Krishnan: The service does evolve over time. Paul mentioned previously the challenges of taking work from an internal team and moving it over; it was very similar in our case. The focus, initially, was very data-driven in terms of Service Level Agreements ("SLAs") and KPIs; as well as ensuring that the business did not suffer. We took a very accelerated approach to getting everything done in a very short period of time, so we migrated all of these functions and there was a significant stress that we were expecting in the business; but that was mitigated by focusing on those aspects that we could measure, manage and monitor early on. Over time, the focus shifted slightly onto looking at performance improvement, efficiency gains, effectiveness, etc.

The initial focus was to ensure that the relationship was built and there was a common understanding of our expectations. The data and metrics upon which we were focusing allowed us to agree on hard quantitative metrics to ensure success.

Over time, we do expect the provider to come back with potential alternative changes as they understand our business better and the nuances of what is important for us. In some cases it is relevant but there are other areas where the market is very new, so providing services to a complex insurance carrier and understanding the nuances of how certain products, as well as the importance of how we manage the business metrics of those, takes time for them to understand. The execution of some areas of business transformation falls on the provider and we tend to have them go in and flush out the details and come back to us with some analysis, as opposed to us building a significant team just to create new products and then have them execute it.

Over time we do see some of it shifting, but not all, and it is still not 'hands-off'. I don't expect a provider to come back to me and tell me how I should look at my underwriting efficiency and figure out where I am going to be making money only, because those are heavily driven by underwriting decisions.

Paul: This is a key point in the success of any outsource relationship; where we see the greatest amount of success is where the insurer and asset manager are including the service provider as early as possible in those discussions.

There are times within the product development life cycle of an insurance company where it is just not possible, for any number of reasons, to include external parties. But the relationship works best when the outsourcers are included in those discussions as early as possible because you need expertise around operational and support models that may or may not influence what an insurer does. Something may look like a great idea from a product perspective but a detailed understanding of what it would take to support the product might uncover costs and other issues that, in extreme cases, might cause the insurer to rethink, simply because it would be far too expensive to see any return on their investment.

Ultimately, including the outsourcer early on means you get better relationships between the two organizations and you get a better product at the back end.

Noel: What type of investment can administrators make that insurers may find difficult to justify?

Paul: As an outsource provider, everything that we do to support this service is core to our business. This includes the investment in our technology or anything else that we do, from a functional perspective. We look at it as an investment to grow our business.

Sometimes, within insurance companies, regulatory compliance and technology updates, to support different aspects of the business, are seen as costs and are a necessary evil. Often, insurance companies will put solutions in place to meet compliance requirements; but the systems can be very inflexible and ill-equipped for the tidal wave of changes that will inevitably follow. For this reason, we try to ensure that our business solutions are built with 'future-proofing', to support multiple clients and built in such a way as to ensure we can respond quickly to any changes that may occur.

When looking at solutions that are standard and available to the entire market, we focus on those things that are not necessarily specific to a business but are more standard. This enables us to build scaled solutions that, from a client's perspective, would be a 'one by one build', so for 10 clients it gets built 10 times. I am not saying that we would build it for one tenth of the cost, but it would be significantly less than starting from scratch each time and it would be a multi-tenanted solution.

Noel: Is there a risk of process and operational duplication, vague lines of ultimate responsibility and protracted discussions on what should be in-house versus outsourced, with a half and half model? Should insurers follow an all or nothing approach?

Krishnan: Defining a strategic view of how you want to run the business, keeping an end-state view of which functions are non-critical in mind, is key to early-stage planning of your operating structure. We took the approach of looking across the board and evaluating the opportunity in one stretch; but there may be other models whereby you could do it, over time, in sequence.

Companies that look at the situation from a functional perspective, focusing on low-hanging fruit in a transactional manner, and are happy with incremental change, are often those that a 'half and half' model suits best. There is often very little political will to initiate broad-scale outsourcing and the opportunity to start small and evolve something big suits them. The bigger picture is that it is important to have a vision which you can execute over a period of time as opposed to revising it – continual revising becomes a constant battle to add internal resources or commoditized process versus external outsourcing.

In our case, we define very early on what we believe to be core to our business and where we believe our focus should be. Everything else is fair game. In some areas we got to this point after a couple of years – e.g. statutory reporting and Lloyds reporting functions - only because of the complexity of some of those functions; however we did have a view that those functions were still going to be outsourced over a period of time.

Shawn: Ongoing support is vital to managing progress, addressing issues and sharing in success. Knowing how an outsourcing partner delivers benefit to your enterprise is important not just for the company, but for the supplier as they can share that connection with the providers of service at an individual level. The mindset of throwing a vendor the keys and walking away is very risky. If you are properly monitoring your vendor and you have integrated touch points you should have very frequent contact and have the ability to constantly monitor the pulse of activity. Waiting for a monthly or quarterly update may either hide systemic issues or raise issues too late to be properly addressed. Monitoring, interaction and oversight must be a multi-pronged approach that includes frequent touchpoints at a process level, monitoring from a reporting or technology level as well as normal management and executive reviews. Ensuring that you have clear expectations built into the contract that connects the vendor to your control environment, SOX or regulatory controls allowing for frequent audits is standard, but many do not execute the audits. This is again a disservice to all parties involved and an outsourcing provider should welcome audits, especially early in the process.

Paul: I will respectfully refuse to accept the premise of the question since I don't believe it is a half and half model - it is a single model. I am not splitting hairs because this is key to the success of any outsource relationship and is consistent with Krishnan's and Shawn's previous comments. The outsourcing process cannot be viewed as a set of processes performed by the insurer on their side, the result of which is thrown over the fence to the provider which, in turn, performs a selection of processes on its side and then sends some form of reporting back.

At the very beginning of the arrangement the focus must be on the end-to-end process and on agreeing the roles, responsibilities and appropriate touch points between the two organizations. Rather than look at it as two processes, it is a full end-to-end process with agreement on who executes which components.

There are certain things that insurers will not outsource and, depending on the type of insurer it is and its location, these things vary. Large life insurance companies in Europe tend to look at the insurance accounting as a buffer to the outside world; so when they are dealing with an outsource provider, their view is they want insurance-ready data that they can include in their insurance accounting platform. That is their buffer to the outside world.

It comes back to this notion of the outsourcer being an extension of the insurance company and doing the work that, historically, had been done in-house. Again, you need to ask yourself 'would I hire these people to run this operation for me and support my business?' If that is not the approach that is taken, you are going to end up with a purely vendor/client relationship. The ideal relationship should be more like a partnership, where the outsourcer helps the insurance company deliver on its strategic goals.

A recurring theme in conversations that I have with insurance companies today, particularly those that manage large amounts of assets in-house, is that they are looking at third party management. One of the challenges that they are facing is that, if they add $100m of general account assets, nothing really changes for them in what they do: whereas, if they go into the market place and offer to manage $100m for, say, a foundation, and nothing to do with their insurance assets, they find it difficult to face-off with the client. This occurs both in getting data from them and then reporting back and performing client reporting, which is something that is different to what they have done for their own in-house assets.

Where insurance companies look to do something like that - which is to leverage their expertise in investment management and provide it to non-insurance assets and non-affiliated parties - they are starting to face challenges that are different to the ones that they face with in-house assets. You see some insurance companies taking that as their first step to outsourcing activities that, historically, they have kept in-house; and that may be the first step that they need to take in looking at the captive assets or the assets of the insurance company itself.

Noel: Thank you for sharing your thoughts on this subject.

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