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The report which assesses how to comply with the latest regulatory frameworks, including Solvency II and ORSA, whilst optimising business functions. Chief Operations, Technology and Information Officers explore innovations in the use of intelligent data and smarter technology systems.

WHITE PAPER

Evolving investment infrastructure for tomorrow's challenges

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Insurance companies' investment businesses face a range of almost unprecedented pressures, at the forefront of which are on-going regulatory change and the low interest-rate environment that continues to lower returns and compel insurers to overhaul their investment strategies whilst managing their risk.

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

As a consequence, we anticipate insurers will increasingly explore new approaches in these areas as they strive to maintain strong oversight and control over their investments and competitive edge in the future.

Regulatory change and the importance of data quality

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

Solvency II - Designed to impose greater levels of capital adequacy and transparency across the industry, the directive will also require much more reporting on insurers' asset data from multiple sources and for many new forms of data – potentially leading to significant new challenges in managing all this information.

Insurers will be required to find new data identifiers and to undertake considerably more data scrubbing and cleansing given the new nature of much of this information and that it will be gathered from multiple sources. A focus on higher standards of governance means all data provided must adhere to standards of being complete, accurate and appropriate[1], while greater onus will also be placed on directors to ensure necessary oversight takes place over information provided.

Derivatives regulation - European Market Infrastructure Regulation (EMIR), produced by the European Securities Market Authority, has been enacted to bring greater transparency to Europe's securities markets and the transactions of investors' counterparties, coming into effect January 2014.

Perhaps the biggest impact on insurers stems from measures introducing central clearing for over-the-counter (OTC) derivatives, as many use these instruments for hedging purposes against investment risks, from interest-rate to longevity risk. These instruments have been traditionally traded on a bilateral basis, a process that has been claimed by many commentators to be notoriously opaque.

By routing certain types of trades (initially credit default and interest-rate swaps) through a central counterparty (CCP), regulators aim to bring more transparency and oversight to the OTC derivatives securities market, but this move will require more collateral to be posted by users than at present. It will also compel additional reporting for T+1 settlement data, for product identifiers and counterparty data.

In addition to satisfying the greater collateral demands of the CCPs, investors will have to report all trade details to a trade repository, which holds all transaction details for the benefit of regulators and investors. Consequently, market participants will be expected to provide regularly-updated records of all of this data.

FATCA – Aimed at combating tax evasion by United States (US) citizens both at home and abroad, the Foreign Account Tax Compliance Act (FATCA) will require all companies to report the financial holdings of US clients to the US Inland Revenue Service (IRS). While not directly aimed at insurers, this measure is likely to be particularly relevant for life insurers, where cash values are provided through annuities, endowments and other payments.

Insurers will be expected to provide the IRS with policy holder information and details of any payments made to the policy holders – again making for potentially significant administrative processes that will necessitate high standards of data management.

Investment strategies and the rise of alternatives

The on-going low interest-rate environment has led insurers to engage on a hunt for better returns, pursuing improved portfolio performance to deliver income for their legacy book of business. Insurers are expected to adopt new and inevitably more complex investment strategies and increase their allocations to particular alternative asset classes. These may include:

1. Source: European Insurance and Occupational Pensions Authority

Bank loans – A recent survey of chief information officers and chief financial officers of insurance companies reported 43% would increase their allocation to bank loans[2], a significant increase from previous years and a trend potentially bringing significant operational impact.

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

Real estate – In the same survey, 37% of respondents said that they intend to increase their allocation to real estate. Investing directly in property rather than through funds brings a higher degree of operational and administrative complexity. Compared to investing in 'traditional' asset classes such as equities, purchasing a property asset involves more counterparties – there is usually a property agent, an independent valuation agent, a lawyer and tax advisor involved in each transaction. There is often also a requirement, particularly for cross-border assets, to establish nominee companies such as special purpose vehicles to hold the property investment.

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

Catastrophe bonds and insurance linked securities – The market size of this asset class has increased significantly since first being issued in the early 1990's, with 2012 bringing new issuance of more than US$6 billion and US$4 billion in the first half of 2013 alone[3]. As these figures suggest, more insurers are issuing these securities to spread risk, with their popularity being because investors receive a premium for taking on specific insurance risks (e.g. earthquakes or hurricanes), which are for the most part uncorrelated to risks and returns in the equity and bond markets.

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

Towards the future

The combination of a more complex regulatory environment and increasing investment sophistication is likely to lead insurers to question the adequacy of existing methods of ensuring operational oversight. In addition, the levels of processing and administration required – both for investments and data – will place operational infrastructure under severe pressure. Robust systems, enhanced levels of control, and the ability to deliver and draw upon accurate and timely data will be required.

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

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

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

Now is the optimum time for insurers to decide how their operational structures may be developed to meet tomorrow's challenges. We are excited to be playing our role in providing the next wave of solutions.

> "In the long term, current systems of oversight, processing and reporting may prove to be inadequate." "

2. GSAM Insurance Survey 2013

3. Swiss Re, Insurance Linked Securities Market Update, July 2013