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NORTHERN TRUST'S DAN HOULIHAN ON THE BENEFITS OF INVESTMENT OPERATIONS OUTSOURCING

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Insurance Asset Manager is pleased to introduce the subject of investment operations outsourcing into our ongoing series of question & answer sessions with the leading firms that practice insurance asset management. An obvious first choice for this Q&A is Northern Trust Corp., the Chicago-based firm which has put a lot of effort into offering a competitive combination of investment management and investment operations outsourcing. Leading Northern Trust's operations outsourcing business is Dan Houlihan, SVP and North American head of global fund services (GFS). He joined Northern Trust in 2008 just as the firm's investment operations outsourcing (IOO) business started to become an even more necessary service as the financial crisis erupted and then ran its course. Six years later, in this interview with IAM editor Alex McCallum, Houlihan expands upon GFS's integrated operating platform that specializes in asset servicing, including middle-office outsourcing, fund administration, fund accounting, transfer agency, and custody.

IAM: How long has Northern Trust been in the business of investment operations outsourcing, and what is the size of the business today in terms of clients and geography?

Houlihan: We began providing investment operations outsourcing (IOO) in 2004 with

the then Julius Baer Investment Management as our first full outsourcing client. Since that time, we have grown to over 45 outsourcing clients with 30 full outsourcing clients and 16 clients for whom we provide component outsourcing. In total, our investment operations outsourcing business supports \$1.8 trillion in AUA. We service clients throughout North America, Europe and Asia Pacific – with several global managers where we provide a single investment book-of-record for their global sites in all three regions. Our clients also manage the full range of equity, fixed income and derivatives – both exchange traded and over the counter. Our largest derivatives-based client has over 40,000 open OTC positions.

Investment operations outsourcing, for a number of reasons, is one of the most exciting growth businesses we have at Northern Trust.

IAM: Are there particular types of insurance company that look for investment operations outsourcing? i.e. large, small, p&c, life, captive, etc.

Houlihan: To date, we have seen the stand-alone investment management arms of large regional or global insurers look to outsourcing. For example, our client roster includes Allianz Global Investors and AXA Rosenberg – both dedicated investment management firms owned by large global insurers.



Where it gets more interesting is with insurers that combine their separate account management with the general account assets – thereby combining both traditional investment operations and the multi-basis requirements of true insurance accounting. We have seen increased interest in this area more recently as outsourcing becomes more accepted across the industry.

IAM: What have been the principal dynamics influencing investment operations outsourcing since the 2008 financial crisis ran its course, particularly as they relate to insurance companies?

Houlihan: Good question, we are an outsourcing provider – so we will always see increased demand through recessions or down market cycles. Starting in 2008, investment management firms were under considerable margin pressure and with that the recognition that a difficult market cycle can expose very high fixed costs. So we definitely saw a spike in demand after 2008. However, we believe the long-term sustained demand for IOO will be driven by the need to execute more nimbly and cost-effectively than is possible on an internal infrastructure. There has been much fodder around the “strategic benefits” of outsourcing such as focusing on core competencies, moving to a variable cost model, etc. However, we believe that there is a much greater value in IOO.

There is an obvious requirement for us to execute in line with the daily, monthly and quarterly operational needs of our clients. However, we also view our operating platform as the mechanism on and through which our clients will execute their business strategy. Whether a firm’s objective is to launch more product faster, increase global expansion, acquire and integrate, etc. – our goal is to be aligned with their strategic objectives and then measure and monitor

how effectively we help them execute. This is a difficult value to monetize but we place a great deal of emphasis on both the operational and strategic side of the equation.

We also believe that the lower- and middle-tier of the market (in terms of AUM) are at the biggest disadvantage. They simply don’t have access to the real or human capital necessary to keep up with the pace of change, cost of regulation and cost of distribution and, therefore, their ability to execute nimbly is strained. Changing an operating model quickly is difficult whereas, on an outsourced platform, you can ideally move faster and pay for what you use. It’s a global platform that can in essence be utilized as needs and market dynamics change.

IAM: Could you describe the key components of a typical investment operations outsourcing mandate? Do insurers have special requirements and, if so, which are the most important?

Houlihan: For full outsourcing clients – our services include everything post-execution through to client reporting. At the core, our main objective is to provide accurate start of day positions and cash to our client’s decision support and trading tools. From there, we provide robust trade confirmation and matching, reconciliation, cash processing, full investment accounting (pricing, income, corporate actions, etc.), performance measurement and attribution, client billing, data management, pricing/valuation, derivatives processing, collateral management and a complete suite of internal reporting and data access tools.

We also offer several of these capabilities on a component basis including the trade matching and confirmation process, derivatives outsourcing and collateral management.

With insurers, it really depends on the existing operating structure. We have been

working with insurance companies for over 40 years and understand the many nuances of the industry. No two insurers are alike so a key to success for Northern Trust is to develop a bottoms-up understanding of each client's needs – then determine how best to optimize our capabilities. Ultimately, we become an extension of their business.

IAM: Northern Trust is a leading manager of outsourced insurer assets. How vital to your success as a third-party manager has been your ability to offer investment operations outsourcing?

Houlihan: We have had a dedicated group working with insurance companies for many years resulting in a broad relationship set across the industry. Our position as a best in class asset manager has definitely helped with our awareness and brand recognition on the asset servicing and outsourcing side of the business. Like traditional asset managers, insurers are dealing with a complex set of pressure points in regulatory cost/complexity, competition, a complicated investment environment and, in many cases, aging infrastructure. These challenges present an opportunity for us to demonstrate our expertise and deliver high value solutions to our insurance clients and prospects.

IAM: As you examine your business opportunities globally, which countries or regions do you find insurance companies in a good position to adopt your investment operations services? And what factors predominate?

Houlihan: At the moment, we are heavily focused on the North American and European markets. However, many of our clients are global, so we do provide services locally in Asia-Pacific including Hong Kong and Singapore.

To date, we have seen most of the momentum for middle-office outsourcing with the stand-alone investment managers owned by insurers, but expect that will begin to change and evolve – on both a component and full outsourcing basis.

IAM: A final two questions. First, how has Northern Trust gone about assembling talented teams to develop and lead its investment operations capabilities? And second, how do you see this business developing over the next five years?

Houlihan: I think the most important thing we did, early on, was to avoid the assumption that, because we had investment management clients for custody, fund accounting and transfer agency, that meant we really understood how the front and middle-office of an investment manager operated. We were admittedly a slow entrant into the outsourcing space but that has served us well. Our approach has been to grow this business organically – avoiding large lift-outs resulting in multiple platforms that are difficult to integrate on the back end. All of our clients are and will be on our single global platform. That is paramount for us because one of the key tenets of outsourcing is to provide economies of scale for our clients – and for Northern Trust. I don't believe you can do that if you're running disparate technology and operating groups for multiple clients

Another approach we have taken is to consistently hire outside talent with deep experience in middle and front office operations and technology. While we always look to promote talent from within, there is no substitute for long-term experience in this space. Many of our team members in product management, client service, relationship management, operations and technology come from investment management firms, insurance companies and/or other IOO

service providers. This ensures we have the experience and external market perspective to keep us competitive now - and over the long term.

This is particularly true with insurance providers. While traditional investment management is consistent across insurers and investment management firms, there is substantial nuance in insurance accounting needs – and that requires proven experience.

With regards to growth, we expect continued and, in fact, accelerated growth in outsourcing over the next five years. Different consulting firms will publish

different numbers but we believe only 20-25% of the traditional investment management community has outsourced the middle-office and perhaps 10% of the insurance segment. Each year that passes, we believe the speed of acceptance accelerates – at least in terms of acceptance that middle-office outsourcing is a very viable option. We are having more conversations about middle office today than we've ever had and don't expect that growth to slow, at least over the next 2-3 years.

IAM: Dan, thank you very much.

