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# INSURANCE ASSET MANAGEMENT, NORTH AMERICA 2016



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Successfully managing assets to meet  
underwriting commitments and  
regulatory requirements

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ASSET SERVICING SPONSOR



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# SPONSORS

## ASSET SERVICING SPONSOR

Northern Trust is a leading provider of asset servicing and asset management services worldwide. With \$6.7 trillion in assets under custody and \$946 billion in assets under management, we serve the world's most-sophisticated clients – from insurance companies, corporate plans and public and government entities to not-for-profits and sovereign wealth funds.



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## 2.1 WHITEPAPER

# How technology is driving outsourcing expansion



**Paul F. Fahey,**  
Practice Lead,  
Insurance Solutions,  
Northern Trust

### SUMMARY

- *Outdated technology cannot meet the demands of today's insurers*
- *Insurers should look for systems with data portability*
- *Support for sophisticated asset classes is important to overcome accounting challenges*
- *Outsourcing is an important part of middle and back-office management for insurers*

The constraints insurance companies face from outdated technology are increasingly pronounced as demand grows for better, timelier data to satisfy the external needs of regulators and customers. Similarly, internal demands for data to support risk and governance continue to rise, placing further strain on an insurance company's aging systems.

As these challenges increase, insurers seek ways to meet them without making costly investments in systems infrastructure. Many have moved beyond the question of whether to outsource, recognizing that technological advancement and a maturing outsourcing industry have made it far easier and less expensive to outsource technology and operations solutions. They no longer need to support their business growth in-house with costly, non-revenue-generating operations. Instead, they can outsource these functions to experts who can manage them more efficiently and cost-effectively.

Having made the decision, what should an insurance company look for in an outsourced solution?

### Data Portability and Flexibility

Growing complexity in global currency trading and regulatory requirements demands streamlined data that often reside on multiple systems and platforms. Look for a provider that currently offers an integrated solution for multiple data sources, producing a single

book of record that can support investment, trading, performance and accounting decision making and reporting. Also important is the outsource provider's ability to produce custom templates and queries. The ability to manipulate and understand data is increasingly important to quickly create and modify reporting to fit specific needs. Having flexibility is essential as technology and needs evolve. For instance, can data analysis be performed on the go via a mobile tablet or smartphone? Does the outsource provider have a report writer with built-in features to manipulate the data to deliver both the required content and format? This should include data delivery integration between the outsourcer and an internal system. Finally, insurers should look for data portability. For example, can the firm run data through an ad-hoc report runner and export to a variety of different formats, including PDF, Excel, and CSV?

### Support for Sophisticated Asset Classes

More sophisticated investment strategies generate greater accounting challenges. Insurance companies may determine they lack the in-house expertise or infrastructure to handle assets such as structured securities, complex fixed-income products, derivatives, bank loans and alternative investments. They may be unwilling to make the needed investment in technology and people to address these challenges. An external investment accounting provider can extend beyond an

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insurer's back office by delivering investment data and insights that enable better investment analysis and simplify data management.

To illustrate this point, recently, a large property and casualty insurer headquartered in the Midwest, with \$15 billion in primarily in-house managed assets, decided to expand its allocation to bank debt and was hiring an external manager for the first time. The insurer's existing accounting platform struggled to comprehensively support bank loans, and the complexities of the asset class threatened to significantly strain in-house resources. With its component outsourcing solution, Northern Trust now supports investment and statutory accounting for the bank loan portfolio. Outsourced services include capture and validation of all bank debt activity, portfolio valuation, accounting and statutory reporting, and data feeds back to the client's systems for aggregated reporting. The insurance company avoided a major investment in systems and specialized talent necessary to effectively support the portfolio by outsourcing those activities to Northern Trust.

### Capabilities for Financial and Regulatory Reporting

Some vendors fail to extend reporting that insurance companies need, such as footnote disclosures and other pertinent financial reporting. Investment accounting systems may not provide this data. As a result, companies may need to manually manipulate data from multiple providers; a costly and time-consuming task. When seeking outsourced solutions, insurers should look for a vendor that provides comprehensive accounting and reporting capabilities that can easily be imported with minimal intervention.

Outsourcing continues expanding into more back and middle-office functions of insurance companies, which for years have outsourced custody and over the last decade expanded insurance accounting outsourcing. With the maturity of outsourcing services comes the recognition that insurance companies have options. They no longer need to support their business growth in-house with costly, non-revenue-generating operations. Instead, they can outsource these functions to experts that can perform them more efficiently and cost-effectively. Most importantly, it allows the insurance company to focus on its core business and spend more time providing its customers with excellent service.

WHAT INSPIRES YOU?

*If you are anything like us,  
you enjoy the view.*

*But you are stirred by the  
promise that greater is still out there.*

ACHIEVE GREATER



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### 3.1 ROUNDTABLE DEBATE

## How are insurers integrating alternatives into their portfolios?

#### Moderator



**David Grana,**  
Head of North  
American Media,  
Clear Path Analysis

#### Panelists



**Marc Tourville,**  
Managing Director,  
Cardinal Investment  
Advisors



**Paul F. Fahey,**  
Practice Lead,  
Insurance Solutions,  
Northern Trust



**Chad Burhance,**  
Chief Executive Officer,  
NewOak Capital

### POINTS OF DISCUSSION

- *Alternative assets can have many definitions, depending on the insurer*
- *Insurers are increasing their exposure to a number of alternative assets*
- *Limitations on alternative asset allocation can be affected by state limits*
- *"Lower for longer" tends to be the consensus for economic growth among insurers*

**David Grana:** The term "alternative assets" is very broad and can apply to many different types of assets. How do you define "alternative assets" from the perspective of insurance investment portfolios?

**Paul F. Fahey:** It depends on the insurance company when referring to "alternative assets." We have seen that large insurance companies have increased their exposure to alternatives in recent years in search of yield. Their view on what constitutes an alternative includes commodities, mortality swaps and infrastructure investments. Some of the smaller insurance companies, who haven't had previous exposure to this space, would likely broaden the definition to include hedge funds, real estate and private equity.

**Marc Tourville:** The definition is ever-changing, so it does depend on the audience. Insurance companies have a number of stakeholders involved: whether it is their internal committee board governance structure, regulators or rating agencies. Each one of these can have a different view or perspective on what constitutes an alternative. If it is defined by liquidity, that would push private assets such as private equity, real estate and hedge funds into that definition. Most definitions would clearly include these as alternatives, but as you get closer on the spectrum to core bonds and public equity, the definition starts to become blurred. Defining whether high yield is an alternative might depend on whether you are talking to a Life or Property and Casualty (P&C) company. There could be an accounting perspective for the definition of alternatives, which might say that anything that doesn't go on Schedule D is an alternative. There could be a rating agency perspective as well. The definition has been changing. I imagine that many years ago, when a number of insurance companies managed their portfolio internally, alternatives were anything that they may not have managed internally. If they had investment grade bonds and domestic equities, I am sure that there were some insurance companies that considered publicly traded international equities as a form of alternative. It is tied to risk tolerance and is not necessarily driven by insurance company size. We know a number of small insurance companies who are

comfortable with the markets and risks and have more alternative assets than some larger, more conservative companies.

**Chad Burhance:** As Paul noted, the persistent low rate environment has created new alternative investment strategies. It has also forced insurers to move into more traditional asset classes, such as commercial real estate, directly. In both cases, the purposes of these exposures are to generate yield that cannot be found elsewhere. At the same time, the traditional hedge fund model that was dominant with private equity in the alternative asset bucket, is slowly going away.

**David: How important have alternative investments been for insurers since yields have been pushed so low?**

**Paul:** As we look at the prospects and clients we are talking to, we are seeing increased exposure to alternative investments in varying shapes and forms. This is a clear indicator that they are important. As you press further into the conversation, you can see that this is being driven by the lower yield environment and the expectation that it will be around for a while. We have found that insurers are becoming more focused on creating more liquidity and are prepared to push out the curve. If you have multiple, underlying legal entities within an insurance company, the parent is looking at ways to pool its cash to make some of it go further out the curve without negatively impacting the overall liquidity of the underlying legal entities. We are seeing more of our clients go down the alternatives route. As they move into these new investment types, they may not have either expertise on the investment side or ability on the operations and technology side to support them and it is posing challenges. They are going to have to figure out a way to support it.

**Marc:** I agree. It all depends on the starting point for the insurance company and their current risk tolerance. Across all risk tolerances, there has been a shift to the next level. There are some insurance companies who have only expanded existing guidelines, implementations or maybe durations. You may change your equity implementation to be a dividend-focused implementation. You may expand your core bond guidelines to increase allocations to BBBs or added Collateralized Loan Obligations (CLOs) as a sector permissible within your guidelines. There are some insurance companies who are only expanding alternative implementations on their existing asset classes. But there are others who have already done that and feel comfortable adding a new asset class. And then there are some who have alternatives who may increase their allocations to the current alternatives or add another one. At all levels, we are getting the sense that people are pushing to a higher orbit depending on their starting point.

**Chad:** Alternative investments have been huge for insurers and are only going to become more important. They will play a big part in ways to fund the asset-liability gap. While there are various viewpoints about how long we will experience this rate environment, the general agreement is that this is the new normal for the next 5-7 years. As a result, funding long term liabilities is a real challenge with traditional investments, hence, the key focus on new alternatives.

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**David: What are the limits within the alternative space that insurers have based on regulations and ratings?**

**Marc:** For our clients, who are predominately P&C and health insurers with state regulations, you've got issuer limits. Many states also have credit, investment vehicle and basket cause limitations. The biggest limitation we see is that anything that doesn't nicely fit into their categories of investments falls into a basket clause. The limitation by state is usually somewhere between 4-6%. The asset allocation work then becomes an optimization within that 4-6%. Within this, you can put investments such as private equity funds, hedge funds, co-mingled credit strategies and tactical allocation strategies, just to name a few. But your limitation on all of these is 5%. It becomes the task of optimizing your objective function, whether that is income, total return or some combination of both within that 5% basket clause limitation.

**Paul:** We talked about this internally, and certainly there is an insurer by insurer determination. It's not one-size-fits-all. Marc does raise an interesting point between the regulatory limits and the rating agencies. You would like for these two to be well aligned. But while a regulatory limit might be one thing, if a peer group is in another tiering, then the rating agencies tend to look at a comparison of where you are relative to your peers. That may dictate what they do from a ratings perspective. It may not be ideal. With multi-national insurance companies, we then have to factor in regulations such as Solvency II and European Market Infrastructure Regulation (EMIR).

**Chad:** I think they are both correct in that there are some clients who are restricted within certain regulations, but no two clients who are alike.

**David: The National Association of Insurers (NAIC) is in process of proposing changes to the treatment of certain asset classes in their investment risk-based capital working group. Is there any indication as to how this will impact alternative assets?**

**Marc:** From what I understand, a lot of their work is in trying to reconcile the differences between the life and P&C Risk-Based Capital (RBC) charges. They are trying to make sure that they are treating the underlying investment risks in a similar fashion. In terms of how it impacts alternatives directly, for years, the NAIC has said that if you have an investment on schedule BA, you need to make the case for why it shouldn't get a 20% capital charge. That includes explaining the underlying risks. They have always had that door open.

**Paul:** Where we are seeing more of their focus is looking at more granularity, particularly in the bond space. Today, they have 6 designations for their bonds. They are looking to have 14, or possibly 19 designations. I don't know where they will end up, but the goal is to distinguish between the higher investment grade corporate bonds and being more granular in the way that capital needs to be allocated. So really, more in the fixed income space.

**Marc:** Another element is that the rating agencies are a little further along than the NAIC. But for a while, both capital models were focused on what the investment vehicle was, not necessarily the underlying risk exposure or asset class. AM Best and the rating agencies are trying to look deeper into what the underlying exposures are in terms of liquidity, rate and market risk. They want to think about these and model them, regardless of whether it is in a mutual or co-mingled fund or a partnership. The NAIC is a little behind on this.

**Chad:** I see the requirement for transparency in new private/alternative credit instruments to be a great challenge for the insurers because of the technology demands. As the allocations increase, it is going to potentially add an immediate focus for the insurers to increase investments to provide the necessary comfort to the regulators.

**Paul:** That is one of the reasons why we are going to see this increased drive around transparency of underlying holdings. The hedge fund industry, in particular, has been challenging at times in the transparency department. As insurance companies move down this path, their size means they carry a bigger stick. That should help them apply a little more pressure, especially if they are getting pressure from both the regulators and the rating agencies for more transparency.

### **David: So no black box-type of investments?**

**Marc:** Most of our clients tend to avoid investments or strategies where they can't understand what they are buying and how the strategies work. There are so many investment strategies and asset classes that have transparency and we don't see our clients willing to give a leap of faith for those that don't.

**Paul:** Their strategies and returns are directly linked to the liabilities they are trying to match. Not being able to understand what they are or there being any level of volatility and opaqueness is just not a fit for insurance companies. As they do become bigger investors in some of these strategies, again, they may be able to apply a little more pressure, so they may influence the level of transparency.

**Chad:** It's very difficult for a heavily regulated investor to not be able to demonstrate investment process and surveillance to manage the associated risk. Therefore, I believe the answer is no.

### **David: What are some of the inherent risks that investors face with a continuation of this low-rate environment, and what are some of the options that insurers have to manage those risks?**

**Paul:** Our investment management arm has taken the view that it is a "lower for longer" environment. It was interesting to see three dissenting votes recently at the Federal Open Market Committee meeting. That gave some people hope for some movement in December. But that remains to be seen. Where we see some of the challenges is for some insurance companies, this is a new frontier. These challenges are matched by those on the investment accounting and operation side of the insurance house.

We see some system limitations from a pure operations and accounting perspective. These new securities have different cash flows, which may not have been accounted for when some of the technology and systems were built a number of years ago. Expanding into new orbits could pose a big challenge. The operations teams that support the investment teams may struggle to provide all of the transparency and reporting on the various securities. They may need to go to outside managers who can provide that level of exposure in those strategies. If they do outsource, is there a technology and operations outsourcing opportunity if the internal investment teams can't be supported by their internal groups?

**Chad:** The only risk investors can take to increase yield is to take on more credit risk. The proliferation of specialty/esoteric finance strategies is still relatively new. And it's certainly new for the scale. We are seeing money moving into various sectors, such as residential and commercial real estate, asset-based loans, middle market loans and direct consumer lending. Investors need to be careful that they understand the credit risk they are undertaking and have the requisite transparency to continue to measure and manage the risk.

**Marc:** The options insurers have to manage risks are similar to other institutional investors: making sure that they do their due diligence on the investments themselves, or the managers who are making those investments for them. What is unique for insurers versus other institutional portfolios is that insurers typically have a lot of cash flows, both in and out. To the extent that an insurer can manage their underwriting operations in a way that provides more positive cash flow, they are trying to increase yields by taking on more liquidity risk to some extent or another. Whether that means going longer in duration or into private asset classes, the implication here is that it buys time to ride out market volatility.

**David: Thank you for sharing your thoughts on this subject.**





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