Northern Trust

Operational infrastructure: Under pressure

Andrew Melville, head of insurance product and strategy for Europe, the Middle East and Africa at Northern Trust, discusses the significant regulatory and investment pressures that, for many insurers, are placing the operational aspects of their assets under significant strain. In responding to these pressures, insurers' decisions will carry both risk and operational implications that may lead them to question the suitability of their current systems of data management, governance and control

INSURANCE COMPANIES face a range of almost unprecedented pressures, at the forefront of which are ongoing regulatory change and the low interest rate environment that continues to lower returns and compel insurers to overhaul their investment strategies while continuing to manage their risk in the most effective manner.

Investment operations departments are among the areas most impacted, and current systems of oversight, processing, reporting and administration may prove to be inadequate to meet the resulting challenges. We foresee that insurers will explore new approaches in these areas as they strive to manage, monitor and report on risk evermore closely, while maintaining strong oversight and control over their investments.

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These types of investments present additional and different risk profiles from the more traditional asset base of insurers. In particular, liquidity and idiosyncratic risks will be different and the risk horizon for these investments may be more varied than for more traditional assets. In terms of risk, investing in alternatives continues to present particular challenges. These risks include:

Liquidity risk

While alternatives can provide diversification and potential opportunities for improved returns, asset classes such as hedge funds, real estate and private equity may introduce additional liquidity concerns given the possibilities they bring of 'lock-ups' and drawdowns.

Investment strategies and the rise of alternatives

A surge in the popularity of 'alternative' investments such as private equity and hedge funds has been well-documented in recent years, as institutional investors seek new ways to search for alpha. For insurers, the ongoing low interest rate environment has also led them to engage in a hunt for better returns, pursuing improved portfolio performance to deliver income for their policyholders and shareholders.

Going forward, insurers are expected to adopt new and inevitably more complex investment strategies and further increase their allocations to new alternative asset classes. For example, a recent survey reported that 43% of chief information officers and chief financial officers of insurance companies would increase their allocation to bank loans, while 37% intended to increase their allocation to real estate[1].

[1] *GSAM Insurance Survey 2013*

Idiosyncratic risks

At individual asset levels, even the best equity risk models will only explain a limited portion of the single securities market volatility. With diversified portfolios, the idiosyncratic (usually uncorrelated) risk diversifies out and quantitative risk models do a good job of adding information to the investment process.

For private equity and real estate, especially in the case of limited direct real estate investments, the limited number of names in most portfolios potentially results in a significant amount of idiosyncratic risk that remains and is not captured by risk models designed for public market investments.

Therefore, the need exists for additional scrutiny, as well as for alternative risk approaches, rigorous governance and an understanding of the gaps where traditional investment risk frameworks do not apply to these alternative investments.

● Risk horizons

Traditional asset class risk models assume some investment horizon. However, inherent in these models is the daily (or even more frequent) pricing data availability. Again, real estate and private equity both introduce return lags and smoothing issues just by the nature of the asset classes. Additionally, the illiquid nature of some of these investments imposes a longer investment horizon.

Aggregating risk across all investments – public and private – can present analytical challenges in trying to measure risk in a coherent way across the business. In order to manage these different risk profiles effectively, maintain a robust operational platform and comprehensive oversight function, insurers' existing systems and processes may need to be enhanced. This is likely to mean improving their technology platforms, as well as putting stronger accounting systems and workflow processes in place.

Furthermore, in a more complex investment environment and, faced with potentially new types of risk, high levels of operational oversight and control will continue to be of paramount importance. Insurers must be confident that their control systems are able to capture all required portfolio information, as well as deliver accurate and timely data. Failure to do so will inevitably expose institutions to unnecessary risk and impact negatively upon standards of governance.

Regulatory change and the importance of data quality

Going hand-in-hand with greater investment complexity, global regulatory initiatives are, of course, continuing at pace and insurers will be subject to requirements dramatically swelling the levels of data processing, aggregation and reporting required of them. These include, but are not limited to:

● Solvency II

As well as greater levels of capital adequacy and transparency, the directive will also require much more reporting on insurers' asset data from multiple sources and, for many new forms of data, potentially lead to significant new challenges in managing all of 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, 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 in 2014. Similar requirements are already in place in the US through the Dodd-Frank Act.

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.

As well as requiring more collateral to be posted by users than at present, the move to central clearing (initially covering credit default swaps and interest rate swaps) will also compel additional reporting for T+1 settlement data, for product identifiers and counterparty data. Investors using these instruments will have to report all trade details to a trade repository and provide regularly updated records of all this data.

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 the 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.

In such instances, outsourcing the aggregation elements of this process to an asset servicer – thereby reducing the need to undertake potentially high levels of data scrubbing and enrichment, handle reconciliation procedures and manage potentially complex valuation issues – may present a solution to this challenge. At the same time, integrated regulatory reporting solutions may also be provided, helping insurers to ensure compliance with regulation, 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 assess and decide how their operational structures and risk management systems can be best developed to meet tomorrow's challenges.

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