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Are insurance companies prepared for the investment infrastructure challenges ahead?

Northern Trust discusses some of the findings of a recent survey of insurers on their concerns for investment operations and technology

AS READERS OF *Insurance Risk* will be aware, asset managers of all stripes are being hit by new regulations in the wake of the 2008 financial crisis. At the same time, they've been forced to develop new types of products and platforms in response to changing investor needs. The costs of addressing these challenges have cut deeply into industry profitability.

As asset managers at insurance companies review their investment operations infrastructures – the systems and processes that support new products, help manage compliance requirements, monitor risk management and report on investment performance – they must assess their ability to meet future regulatory and financial challenges. With the right systems, insurers will continue to prosper. Without them, survival will be a challenge.

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Calm before the regulatory storm

To determine whether insurance companies are prepared to meet the regulatory and competitive pressures on the horizon, we surveyed 251 insurance executives from the US and Europe about their concerns for operations and technology, now and in the future.

Although the new onslaught of regulation presents a huge challenge to the industry, most of the respondents to this survey reported satisfaction with their current operational infrastructure processes and systems. The question for insurers may be: do they appreciate the implications arising from the flood of regulatory changes headed their way?

Two-thirds of respondents asserted their investment systems perform "well" or "extremely well". Respondents are particularly satisfied with how their operational infrastructure systems are handling current financial regulations, with 64% reporting that their current operational infrastructure systems are successfully meeting regulatory requirements. However, when asked about the ability of their current systems to meet future regulatory requirements, more than 70% of respondents reported they are either concerned or unsure about whether to be concerned.

Now is not the time for a lack of confidence. With their systems' future abilities likely to be tested severely, insurers must address and remedy a problem they may not yet fully appreciate: the inability of these systems to meet the demands of an increasingly complex regulatory reporting environment. The operational landscape of the future will require sophisticated infrastructure systems to manage and make sense of investment data – an administrative burden that is sure to stretch insurance companies' resources.

In the US, certain insurers must now comply with Dodd-Frank legislation, which regulates firms that could pose a risk to the country's financial stability. Insurers included in that category will have to meet new, yet-to-be-determined risk-based capital requirements, adhere to leverage limits and fulfil liquidity requirements. They will also have to develop detailed reports on their credit exposures and risk concentrations, and will be required to set quantitative limits on proprietary trading and investments in hedge funds or private equity funds.

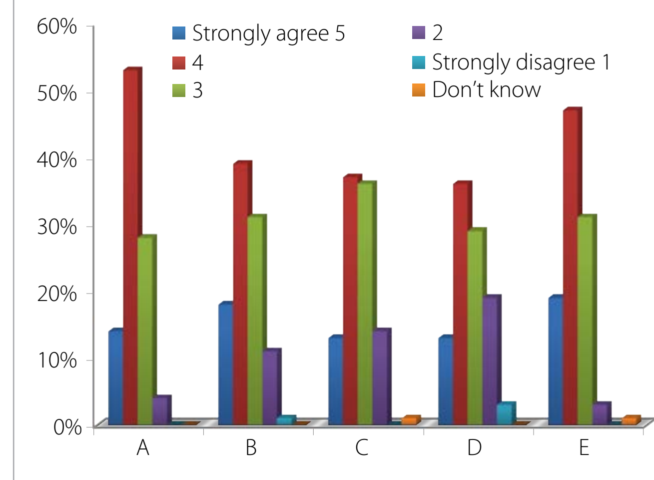
In Europe, regulators have of course taken additional steps to make sure insurers are able to meet their claims. Solvency II imposes additional capital requirements and regulations on governance and risk management, and requires further disclosure so supervisors can identify risks earlier. Insurers will have to determine how risk within individual business units affects the company's larger risk profile. This information needs to be accessible to a variety of groups within the company: data and IT teams; actuaries; compliance teams; and risk and asset/liability specialists. Solvency II is also likely to require increasingly detailed risk assessments of a firm's assets and liabilities.

Efficiency maelstrom

Asset managers at insurance companies have a second big challenge ahead. Spurred by changing investor needs, insurance companies are coming under pressure to develop and support new product and delivery platforms. And they must do this as revenues remain flat and the cost of maintaining legacy systems continues to rise.

Our survey respondents seem remarkably complacent in the face of these challenges. While 78% indicated the costs of their operational infrastructures are "competitive" or "very competitive," industry experts believe insurers may be seriously underestimating the costs of maintaining their existing systems. Experts point out that, while costs may be competitive with similar costs at other insurance companies, they are much higher than those at the technologically savvy firms managing mutual funds, index funds and exchange-traded funds. Insurance companies do not merely compete against other insurers – they have to expect customers will compare their performance with that of other types of investment vehicles.

1. How much do you agree or disagree with the following statements about the degree to which your processes and systems are customised?



Key: A. Highly customised to your business; B. Too integrated to outsource; C. Customised with obsolete code that needs to be updated or discarded; D. Too dependent on particular vendors and difficult to maintain; E. Need to move to industry standard systems so you can buy "plug and play" solutions

Results were aggregated using a 5-point scale, where 5 denotes respondents "strongly agree" and 1 "strongly disagree"

Investment operations outsourcing platforms can help investment managers handle the flood of new investment securities. Functions that assess the characteristics and risks associated with new alternative investments in hedge funds, real estate and derivatives need to be integrated into an investment manager's larger systems. Rigid legacy systems were built for standard exchange-traded, fixed-income or equity investments. The move to non-standard investments requires insurance companies to either retool or create expensive and time-consuming 'work-arounds'.

Survey respondents seem to be aware of this challenge, as more than 65% believe they should move away from customised and hard-to-manage software vendors and systems, and move to standard industry platforms provided by the outsourcing industry. By outsourcing investment operations to firms accustomed to the challenges of alternative investments, insurers don't have to force their systems to keep up – they can leverage the expertise and scale offered by a provider who will innovate to address changing regulations.

Facing talent headwinds

The failure to give up legacy systems has presented insurers with another problem: they may soon be unable to find the staff necessary to maintain those systems. Many legacy systems have been modified by multiple programmers over the years with little documentation, so maintenance becomes a challenge as those programmers retire or leave the company.

Nearly 70% of respondents expect that up to one-quarter of their staff will retire in the next five years. Replacing those employees with top new talent will be difficult. The best university graduates, who have been studying Java and Hadoop, are unlikely to find working at a company running COBOL programs on old mainframes to be attractive.

Insurance companies are also facing increasing demands from customers who want access to their investments via new platforms and products. Although it is possible to connect new devices to legacy systems, it is often extremely costly and the results are far from optimal.

Looking toward outsourcing

Insurers who believe they can solve these technology challenges on their own need to look beyond their industry confines at the way other companies are addressing similar challenges. In most cases, those companies are working with outside vendors to both modernise their systems and reduce their costs. But, according to our survey respondents, the number of insurance companies considering full investment operations outsourcing is expected to decrease from 14% now to 10% in five years, despite the oncoming pressures.

Further, with approximately 50% of respondents indicating their systems already are between five and 10 years old, and 50% acknowledging their systems are customised with obsolete code, some questions arise: how do insurers think they'll be able to keep up with the demands headed their way? Why do they feel their systems will be able to provide the increasingly complex data they will need in the future, but doubt their systems' ability to address the increasing number and scope of regulations?

The disconnect highlights a significant concern: insurers don't know what they don't know. Current investment operations platforms were designed years ago to handle a different business model, by programmers who could not have predicted the transformation of the industry. A system built 10 years ago would not have been equipped to handle the economic crisis, the complexity and expansion in financial instruments and spiralling regulatory requirements. Industry watchers say insurers haven't realised that the issue is far greater than a simple systems upgrade.

And, though insurance asset managers are waking up to the need to look to outside vendors, their companies don't appear to be acting with urgency. Currently, more than half of the respondents' companies are spending less than 25% of their firms' operational resources on new initiatives; 48% have indicated they'll be looking at an outsourced component five years from now. But five years may be too late.

The asset management operations of insurance companies are certain to face higher regulatory costs that will squeeze their profit margins. These costs will force many to change their operational structures, while new regulations will force them to meet additional capital requirements. Asset managers at insurance companies will have to change their obsolete systems sooner rather than later. New regulations and the high costs of inflexible legacy systems won't leave them with a choice.

For more information on our research visit *northerntrust.com/insurerinvops* or contact:

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