

Scott Kurland

Episode 234: Avoiding Negative Yield: Flexible Co-Sourcing Models for Insurance Investment Operations



GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. My name is Stewart Foley. I'll be your host. We have got a very interesting podcast for you today, and it's going to require us to introduce a new concept, something that I'm referring to as negative yield. And the title of the podcast is Avoiding Negative Yield with a Flexible Co-Sourcing Investment Operating Model. We're joined today by Scott Kurland, who's the managing director at SS&C Technologies. Scott, you head up the insurance solutions team there. You're a repeat guest and I'm thrilled to have you back on. You're also a good friend, so welcome, welcome, welcome. We were just talking about the travel challenges that are going on right now worldwide, and I hope you get out this afternoon. So welcome and thanks for being on.

Scott: Yeah. Thanks, Stewart. Always happy to be back and I think this is an exciting and timely topic for us to chat about today.

Stewart: Absolutely. You and I have conjured up this negative yield concept, and I mean it's interesting to me because a 10-year treasury and a 10-year private credit instrument have a very different yield. There's a pronounced trend that is strong and ongoing toward private credit, private structure, and other income-producing investments, some of which are rather cumbersome to account for. And the effort that it requires to account for and administrate an asset, I'm referring to as negative yield. Because there is a cost to it. No doubt about it.

And the thing that I have always admired about the insurance industry is the loyalty that most companies have toward their employees. So for the most part, I mean, I've been to a number of family picnics and events and so forth. There's almost a family feel in some insurance companies and a lot of times the accounting staff has been on for many, many years. They may not have the expertise to deal with some of these newer investment forms. So you and I were talking about this co-sourcing model where you can have your cake and eat it too, which is to say that you can account for some things internally and if you have the right partner, you can outsource part of that investment accounting and administration and have that work seamlessly together to reduce the drag or negative yield that comes along with some of these investments. So that's the topic and concept today. Can you talk a little bit more about how this co-sourcing concept actually works?

Scott: Yeah, absolutely, Stewart. I think you hit the point right on, which is that in today's environment with premiums have steadily gone up in the insurance space across all lines of business. So to the extent as an insurer, you can generate a higher yield on your investments, you can offer more competitive policy rates in the marketplace. It's a way to offset some of that creeping premium costs.

So the idea with co-sourcing is that you can go ahead, you can explore and enter and invest in and embrace investment opportunities that can generate higher yield while doing so with an operating model that's re-scalable and efficient. And so just maybe for those that are tuning in to define co-sourcing as we see it is that co-sourcing really refers to an operating model, an investment operating model that would enable insurers to retain certain functions that they see are core to their business with their own internal staff using vendor-provided software, while selectively outsourcing certain functions that could be better performed through improved technology, automated processing or external specialized expertise either by an asset class or a specific type of process throughout the investment lifecycle.

Traditionally, insurance companies, the mid and larger sized players in the market have licensed third-party software or built out proprietary applications that are installed and managed locally, or maybe they've been shifted to some extent towards the cloud. But as cloud-based solutions are becoming more commonplace, moving from an on-prem software environment to a fully outsourced model sometimes is a bit of a dramatic step too far.

You don't want to take everything shifted out, lose governance oversight, and have staff that has a knowledge base that you can't continue to put to use. So you can do co-sourcing if you have modern technology that's cloud-based. If you think about, it's the co-source partner acts as an extension of your operating and accounting and reporting staff, but they're working through the same collaborative platform that you are. It's two people sitting on opposite sides of the window pane looking at exactly the same data set at the same time.

So that allows you as an insurer to go out and gain scale, gain that specific expertise where it makes sense for you while still having your staff perform the key value-added functions that you require to do your business. And it just provides more flexibility for you to adapt and respond to investment opportunities or even new business opportunities. Maybe you're acquiring a new book of business, you're entering a new jurisdiction or location, or your investment mandates changed and you now have the opportunity to go left or go right.

Stewart: You brought up a couple of great points there, and the first of which is... And I don't think everybody thinks about this all the time, which is a more competitive rate of return on an investment portfolio certainly helps the ROE of an insurance company, but it also helps that insurance company be more competitive on rate, particularly for those risks that they really want to write. I think that that creates a competitive advantage, at least from the standpoint of flexibility on the underwriting side, which is a connection that's not always made.

The second thing is you talked about is the certain asset classes and the one that comes to mind is resi whole loan right? And you go, "Wow, what a great asset class." It's got great capital treatment, yields are there, so on and so forth. But there's a large number of line items associated with that that have monthly pay downs, and there's a lot of things going on there.

So being able to account for that in a very efficient way actually helps you realize the stated yield on the investment and avoids the negative yield that I mentioned at the top of the show. I do think that insurance companies are examining the structure of their investment operating model. I do think that there are more folks looking at that.

If I'm a CIO or a CRO and I'm thinking about co-sourcing, how should I be thinking about the division of responsibilities between my internal team and my co-source partner, in this case SS&C?

Scott: Yeah. That's a great question because if you buy into the concept of co-sourcing and the benefits that it can provide you, then the question is how do you slice the apple to do it most efficient? So we're actually working with a number of insurance companies today, and I've got maybe two actual use cases that I can describe. But one way to think about it is you can divide up responsibility by function.

So if you look at the investment life cycle, there are key buckets that we look at. So one is, for example, technology and infrastructure, interface management, managing connectivity to custodians, asset managers, pricing, market data rating sources, corporate GLs, things like that. So managing the data, managing the interface, that is an area that maybe you don't want your IT team to do and you want a co-source partner to do.

Okay. Middle office operations. So trade processing, reconciliation, corporate actions, facilitation, security data maintenance, valuations, things like that. That's a middle office function that maybe isn't core and you want somebody that has technology, has some AI capabilities and has a very lean, mean operation staff that can do that on a 24-hour overnight cycle and just make sure the data is in, it's processed, it's reconciled, it's good to go.

Then you have things like core investment accounting, managing all of the elections and the nuances of accounting treatment for different asset types, the different valuation methods that are required for public versus private investments or equity versus credit investments. And then further downstream you have the whole aspect of regulatory reporting as an insurer on a quarterly and annual basis. If you're US insurer, you have to prepare your NEIC statutory reporting, so all of your schedules, put note disclosures, things like that.

If you're operating in Bermuda to BSDR, it's BMA reporting or it's SEMA and Cayman and the lights go on. And then there's then risk and performance analysis and technology and reporting. So those are by function, if you think about that. And you can sleeve off each of those pieces, and we have, for example, a \$23 billion dual line insurer today that's looking to work with us to have us take over as the co-source partner, all of the data interface management and middle office operations, the processing, but their accounting staff is still going to be required to run through the accounting, close the books at the end of the month, produce a GL, produce the quarterly and annual financial and regulatory reporting, and sign off on the numbers. And that's an example of a division of labor.

The other way to look at it is by asset type. So maybe you as an insurer are perfectly well staffed and you've got a well-oiled machine when it comes to your core, let's say plain vanilla securities in your general account, fixed income equities, publicly listed investments. But you now have a mandate, Stewart, as you mentioned, to go into the resi whole loan market or commercial mortgage loans directly. Those are volume intensive. They're deal specific. There are a lot of different documentation that goes along with them. You are dealing with issuers. You're dealing with correspondents. You're dealing with agent banks in many cases.

If you have thousands or tens of thousands of resi loans, you have to update the rates on those if they're floating rate instruments. And that affects accounting. If you don't have the in-house expertise to do that full end-to-end processing, we're working with another life insurance company that has about a \$25 billion book of business and 3 billion of it is now in faults and loans. And they are working with us to be the co-source partner, end-end to end to handle all of those loans and alternatives, starting with the event origination, all of the deal and document processing, the accounting and ultimately the production of a schedule BA or Schedule B that will accompany their core Schedule D investments when they go to do their NEIC report.

If you think about the core ways to slice it up, it's asset or investment specific, or it's functional specific, and you can do that using the same collaborative technology where the two teams work in concert with one another.

Stewart: Yeah, it makes total sense. I do think it's worth mentioning, and you mentioned this earlier, but insurance companies are hesitant to give up control on essential operations. You don't see people outsourcing their underwriting. They won't do it. And the investment side is very much the same way. People want control over that. So how do you address that when in a co-sourcing environment, given those sensitivities, and I don't think... It's not perfectly consistent company to company, but I think generally that is the state of affairs. How do you work with folks around that sensitivity?

Scott: Yeah. So I think a lot of it comes down to having real time transparency into the technology and the processes that are performing all of these functions, right? Regardless of which human on which team is doing the update or doing the verification, having transparency so that both sides of the, as I said of the window pane, see the same information and the same data updates can query that, and if there's an anomaly can communicate with each other to resolve it, I think is really, really, really key.

And the cloud-based mobile and desktop friendly technology with real-time processing allows that in an environment where you're doing month over month or overnight batch processing and you've got to sit there and wait an hour to run a report to know where you stand with something. It doesn't bode well to have that control or governance on functions that you may otherwise be willing to hand off to a co-source partner, but you're still responsible for.

You still want that information. I think the other thing we've done as a way to mitigate that is we've taken the ability to create digital checklists as a control process within our platform singularity. And that digital checklist is, for example, here are all of the steps that need to be reviewed, verified, and signed off on in order for me to close my monthly account, for example. And depending on who's responsible, you can have a maker check. So we could have somebody on our co-source or outsource team perform the function we've reviewed and said we're good. And then the client staff goes in, verifies it, ties out and says, "We're good, and add their comments in, and then that item gets checked off and you move to the next one."

Stewart: What was the term that you used?

Scott: It's a digital checklist. It's basically a digital checklist and control procedure.

Stewart: I thought there was a term. It sounded like it ended in maker. Was there...

Scott: Maker-checker.

Stewart: Maker-checker.

Scott: Maker-checker process, right? So the maker is the one that's performing the function, the update and the checker is verifying that everything looks the way it should and signing off on it. Think about it like a manager review process, and that all becomes digitized online if there's an open item, if there's an agent and you can see it. And it's great for an auditor to come in too and say, "Well, show me your process. How is it documented? How is it flow? What are the steps and who's signing off on?" And if you have that defined as part of your co-sourcing arrangement, then it really is just two areas of the same team working under the same operating model.

Stewart: What are the limits of this? I mean, for example, are there asset classes that you can't handle? Are there asset classes that better in a co-sourcing environment than others? Talk to me a little bit about where am I going to get a no. Scott: Yeah. I think the short answer is that SC&C, I mean we handle everything under the sun asset wise and we actually have a lot of volume and expertise in the alts and the credit space because of our hedge fund business and our alternatives business. So the short answer to your first question is no, there isn't an asset type that we can't handle today. We've seen it all. That said where we're seeing our insurance clients get the most bang for their buck, their ROI are on the non-standardized, non-publicly traded investment.

If you think about what goes into handling a portfolio of 250 alternatives, limited partnerships, joint venture vehicles, direct real estate, things like that, and all of the capital calls, distribution notices, funding and unfunded commitment reconciliations, wire processing, that has to happen around that in order to get timely valuations, timely cash flows, it's a lot of work. Rather than throwing bodies at it, we're throwing AI technology.

So we're processing 250,000 of those event notices every quarter at 85%, 90%, 95% straight through processing efficiency rate. So the humans still verify and they review, but there's only maybe 10% of them that they have to touch. And that allows us to get through that really, really quickly and efficiently at the end of each month and end of each quarter, and then we can report that back up to the insurer as part of their overall reporting structure.

Whereas if you were trying to do that internally at an insurer, you might have to hire six people and they're only really utilized at max three, four days at the end of each month in each quarter when everything bulks up and all of those notices come in, right? It's not an efficient use of human capital, let alone capital. So that's a perfect example where you could avoid negative yield and leverage an operating model where we have a well-oiled machine around those things and you could scale up your investments in those type of things.

Same thing for resi and mortgage loans. Those are very volume intensive rate intensive term and deal term intensive that allow for us to help with standardization and scalability, which I think is key.

Stewart: So it's interesting because the use of AI is somewhat polarizing, right? In the insurance space, there's been situations where folks have tried AI for underwriting and they've gotten some unfavorable results. And so I'm absolutely a pro-AI use. I mean, absolutely. But what would you say to someone who hears AI and gets scared? You're using AI and machine learning to attain this 85% to 90% straight through processing rate that you'd referenced. Can you just talk a little bit about that to try and maybe demystify how that's happening?

Scott: Yeah. I think when we're talking about use of AI, we're doing it in a very structured environment with very specific data sets where we know the data elements that we're looking for that are necessary to process and account for an investment. This isn't generative AI coming up with a new idea or making a recommendation or interpreting sentiment off of volumes of information that may be accurate or non-accurate, right? We're taking in notices of actual event activity that's happening by an investment or an asset manager, but it's coming in different shapes, sizes and forms and emails and PDFs and word documents and maybe the label is a little bit different.

It's a pay down instead of a payment amount or something like that. We're learning that we're going into that document and saying, "We need these eight data elements, a date, a rate, an amount, deal ID, etc. in order to be able to extract that out, verify it, and then process that in the accounting system to update values, cash flows, things like that."

And then we have a human that looks and says, "I only got three out of the four data elements from the notice. Where's the fourth one? I need the fourth one to finish processing." The human will go in, find it, update that fourth one and send that back into the AI engine to know that that's where to look for it going forward from this counterpart. So it's that type of things where we're parsing and reading and digitizing information that's coming in slightly different flavors and colors and shapes, but we know the information and the end result that we need and we have experts that are validating that it is what's required in order to downstream process.

Stewart: Is it fair to say, and I don't want to put words in your mouth here, but is it fair to say that there is always, and I'm careful with the use of that term, always a human checker at the end of the AI process? In other words, someone is reviewing the results, they're not going straight into a report and so forth, right?

Scott: As part of our county control process, you have to make that the data is accurate and complete. Just like in a public investment, you could take a security attribute and a price update from Bloomberg, but somebody has got to look and make sure that that's right and that the variance isn't 70% off what it was last month that's going to cause this big anomaly and the data. So you have thresholds and governors on the system that says, "Hey, within an allowable tolerance," this has to make sense or it's going to impact my reporting and it's going to raise questions in an audit.

So you're still going to have that process. I think where the AI comes in is it demystifies it in that it lays out, "This is the digital document I received, here are the six data elements I pulled out, here's the one that was missing that human added and now go." So it's not a black box. You're still able to see the inputs and outputs that came in, and then if humans verifying the outputs are what they should be, I think that's the big difference in terms of how we think about using AI or intelligent automation in this case to generate scale and operational efficiency on some of these more esoteric private investments.

Stewart: I look at it like if I've got a team of three investment accountants and we've bought some things that are cumbersome to account for, the co-sourcing opportunity essentially allows me to augment that team with a new capability that it's almost like an extension of my existing team. And that team now has some help, if you will. I mean, am I thinking about that in the right way?

Scott: You are. And the other advantage is I like to use the term pay by the drink. So what that means is you're only paying for those services when and where you need them. So maybe you need them at the end of the month, the end of the quarter, a specific event happens or you're onboarding or requiring a new book business. And for speed to market, you need that additional army to help you get it done and get it standardized and into your operating model. You can do that, and it's much easier to do that with a co-sourcing partner than to go out and try to hire in advance for that and have tenured people and then figure out how to repurpose them once that event has occurred or what to do with them on the off time.

It just allows you as an insurer to focus on your business, which is generating yield, reducing risk, and being able to service your policy with what you underwrite. And you want to be able to do that in the most efficient manner and scalable manner, and flexible manner possible without having to reinvent the operating model every time. You may change your investment policy or the flow of what you're doing.

I think that's the advantage of the co-sourcing model. And I think that the things to think about, Stewart, when you're looking at co-sources, A, when you're evaluating a co-sourcing partner, do they have the right technology and do they have the right areas of expertise that you're looking for help for when you're thinking about the functions or asset types that you need co-sourcing assistance with? And is the operating model flexible enough that if you have to pivot left to right or up or down, that partner can work with you seamlessly to make that change without, again, having to redo your whole operating.

Stewart: And you bring up a good point because you can hire a temp accountant, but a hire a temp insurance investment accountant that has the expertise necessary, blah, blah, blah, is very difficult to do. Right? So just one other question on limits. Does it matter where I'm domiciled? Can I be a Bermuda insurer? Can I be a US domiciled insurer? Can you handle those different domiciles?

Scott: Yeah. I think when you ask, does it matter? It matters only to the extent that as a co-source partner, do they have a staff and jurisdictional expertise in the regions with which you operate? So we have teams in Bermuda, and Cayman, and Canada, and the UK that will work with insurers that are subject to those jurisdictions and regulatory reporting requirements and the nuances of accounting and the reporting.

So in certain markets, you have risk-based capital or solvency to reporting, or you have different ratings, classifications in how you operate, right? And so you just need to make sure that the co-sourcing partner, if they're taking on some of those functions, can properly account for and report on those investments the way the local regulators and jurisdictions require. That's really the only limit, but we work with clients in all the different regions for that purpose.

Stewart: I have learned so much. What is a takeaway or two for our audience as we wrap here?

Scott: Yeah. I would say take a good look at your existing operating model and in areas where you have pain points or limitations that are hindering you from generating a more yield efficiently and not getting into the negative yield slump. We would love to engage in a conversation with you and can talk you through what a potential co-source or collaborative model looks like with your existing staff and resources, and technology. We're in the process of publishing a bit of a guide on that, and we have an interactive site that allows you to look at different ways you can slice and dice the apple and what those functions and ramifications are. They help you set up your own blueprint about how you might go about doing this. So we'd love to engage in those conversations.

Stewart: Yeah, I think we're going to make that link available in the podcast description so that someone can get access to it and it'll also be on our site. So I think that's a terrific resource for our listeners to use. I know you're getting ready to run out the door to go on a family vacation, so I want to wish you well on that and have fun. It sounds exciting and a great time. I'm glad you're getting to have some time off with your daughter and your family. So I've learned a lot today, Scott. Thanks for being on. It's always great to see you and thanks for taking the time.

Scott: Always a pleasure, Stewart. Thanks very much.

Stewart: My pleasure. Thanks for listening. If you have ideas, please shoot me a note at stewart@insuranceaum.com. Please like us, rate us and review us on Apple Podcasts, Spotify, or wherever you listen to your favorite shows. My name is Stewart Foley and this is the InsuranceAUM.com Podcast. We'll see you next time.