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Outsourcing the Investment Function:
Opportunities for the Smaller Insurer

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Smaller insurers, while frequently blessed with nimbleness and clarity of vision, nevertheless face long-standing obstacles to success. Chief among these is competing with the critical-mass efficiencies that their larger brethren enjoy in product sourcing and delivery and in investment activities. However, recent events have put large-scale economies within grasp of many small companies, especially in the area of investment management, and have brought "large company" service and performance standards to the smaller insurer. This article briefly surveys some of the technological advances that have powered this revolution and identifies the benefits that small companies are realizing because of it.

Notwithstanding recent unpleasantness in the stock market, the "New Economy" truly has had a democratizing impact upon the distribution of information and the ability of companies large and small to conduct business from afar. New technology has permitted small insurers to "level the playing field" in a number of powerful ways. Certainly the Internet has revolutionized the distribution of insurance product, constituting an empowering force for insurers without entrenched (and costly) "bricks and mortar" distribution systems. Accounting and administrative packages, previously available only as big-ticket systems outlays, now see their functionality commoditized and broadly disseminated through both the Internet and company intranets. These trends relentlessly force down the cost of underwriting, issuing and maintaining an insurance policy and of providing timely, relevant and reliable information for managerial decision-making.

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The ASP Phenomenon

Such technological advances have not been absent on the asset side of the balance sheet. Technology has brought a level of immediacy and pervasiveness to market information that enables small insurers to maintain intimate monitoring of asset performance. No longer does a small company only get a look at asset transactions and performance on paper reports six weeks after the close of the quarter. Much of this benefit derives from the explosion in the use of Application Service Providers (ASP).

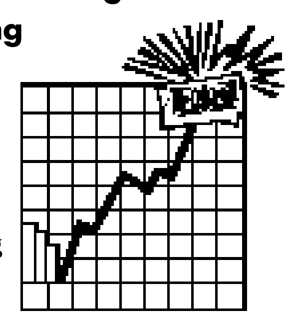
ASPs spare users the time and expense of procuring or developing their own computing infrastructure for trading, analytics,and reporting. Instead, users access computing resources through the Internet that have already been established at a convenient network location and manned by a team of experienced specialists. This approach, therefore, affords the small insurer the opportunity to purchase economically priced functionality slices, not an expensive, full-fledged system.

Most noteworthy is the rise of ECN-based electronic exchanges like Island, a unit of Datek Online Holdings, and Instinet (from Reuters). These are computer trading systems that automatically link buyers with sellers. For small insurers, they represent a powerful means of reducing commissions and eliminating gaping bid-ask spreads that are typically gobbled up by marketmakers. While the fixed-income universe has lagged in moving to electronic exchanges, a number of initiatives are under way to extend these cost-saving benefits to bond investors. And a consortium of twenty-three leading derivatives dealers, like J.P. Morgan Chase, Goldman Sachs, and Deutsche Bank, are establishing SwapsWire, a common Internet protocol for electronic trading of interest-rate derivatives.

Advances in Securitization

Securitization is the process of repackaging financial assets into securities, generally from less liquid forms into more liquid forms. Mortgage-backed securities and collateralized mortgage obligations are examples of securitization in action. These instruments repackage residential mortgage loans, and in doing so, bring valuable liquidity to the mortgage markets and allow investors to more easily participate in this asset class. (The insurance industry traditionally has securitized policy loans or future surrender penalties as a way of increasing financial flexibility and efficiency.) Recently, this practice has been extended to the high-yield bond markets. Historically, smaller insurers have been unable to effectively gain exposure to the high-yield markets due to the twin obstacles of odd-lot trading costs and inability to diversify. A collateralized bond obligation (CBO) pools a large number of high-yield bonds in order to gain the benefits of diversification, then securitizes them into tranches of various seniority and credit quality. For example, an equity tranche absorbs initial losses, followed by a mezzanine tranche and finally a protected senior layer. Small insurers then can purchase these conveniently sized securities according to their particular tastes and capacity.

Investment Management Outsourcing



While executives at small insurers often possess considerable investing expertise and savvy, seldom is it economical for these companies to retain the investing function in-house. Beyond the economies of scale to be realized by outsourcing nuts-and-bolts activities like accounting, regulatory compliance, and trade execution, full-service external investment managers can deliver:

- Assistance with investment policy development, including guidelines, limits and control procedures
- Access to specialty asset classes, like convertible bonds and asset-backed securities, that can add valuable punch to a small insurer's core holdings
- Advanced asset/liability expertise and advice, a critical ingredient for prudently balancing risk and return
- Sophisticated asset allocation technology to support strategic and tactical portfolio actions
- Access to deal flow typically available only to large institutional investors
- The ability to perform cash flow testing and other risk assessment exercises required by regulators

Thus, through outsourcing of the investment management function, smaller insurers can effectively and economically harness the market coverage, trade execution efficiency, and performance attributes of an experienced asset manager.

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