

# The evolution of the insurance treasury function – Treasury's strategic role and what centralization means for the sector

The insurance sector is facing cost, capital and profit pressures from numerous industry challenges including the eurozone debt crisis, heavy losses on catastrophes, and the low interest rate environment. The sector can also expect increased complexities in compliance, and further pressure on capital and profits with the looming implementation of Solvency II and other upcoming regulatory reforms.

To mitigate these challenges, companies are focused on implementing strategies to better manage risk, increase efficiencies and minimize costs, and are also exploring new markets to grow revenues.

This article explores the evolution of treasury into a strategic function that is aligned with overall company objectives, and reviews some of the key trends in insurance treasury management.

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## The evolution of the insurance treasury function

Historically, the treasury function had a limited scope, covering activities such as managing short-term funding and traditional cash management. However, there have recently been many developments in insurance treasury management. The role of treasury has been evolving into a strategic function in recognition of the need to maximize shareholder value in tandem with the already established focus on policy holder returns. John Whorwood, Group Treasurer of Legal and General, commented on the changing role of treasury at the recent Insurance forum held by J.P. Morgan, "I joined Legal and General in 1987 to establish a corporate treasury function, which was the first of its kind for the UK insurance industry. Since then, many other companies in the sector have taken similar steps and are realizing the value of strategic treasury management."

Currently, there is a broad spectrum of companies within the insurance sector at varying stages of treasury development. Although treasury advances are not as widespread as those in the corporate sector, insurance group treasurers are increasingly aligning their objectives with the firm's strategy and are playing a leading role in defining broader risk management policies and implementing and monitoring controls for the global organization. For many companies, treasury is progressively being seen as a provider of strategic advice to senior management - who are recognizing the ability of treasury to achieve returns that benefit the entire organization.

Christof Nelischer, Group Treasurer of Willis, articulated this concept, "Our treasury objectives and initiatives are derived by the strategic objectives of the firm. We are focused on delivering a best-in-class treasury function which understands corporate strategy and partners with the business to achieve common goals."

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Treasurer of Willis

## Key concerns of insurance treasurers today

Solvency II and a host of other regulatory changes are due to impact the sector. As well as imposing higher capital requirements and generating increased cost pressures, regulatory reform is putting a greater emphasis on risk management and transparency. Companies will need to implement processes to enable better visibility and control as regulatory reforms demand a higher standard of risk management and corporate governance across their entire operations.

Additionally, as many companies embark on international expansion to tap into higher growth markets and diversify their operations, managing global cash takes on an increased complexity and importance. Firms with a very large geographical spread may suffer from a lack of visibility and control over local operations leading to increased fraud and inefficient operations.

In light of these concerns, treasury is increasingly focused on implementing best practices and strategies around the following key themes:

- Managing the impact of regulatory changes
- Enhancing visibility and control
- Driving for increased efficiencies
- Working capital optimization
- Maximizing liquidity, including risk management and diversification
- Centralization strategies to manage growth, including the effective deployment of technology (including SWIFT, eBAM, and upgraded Treasury Management Systems)

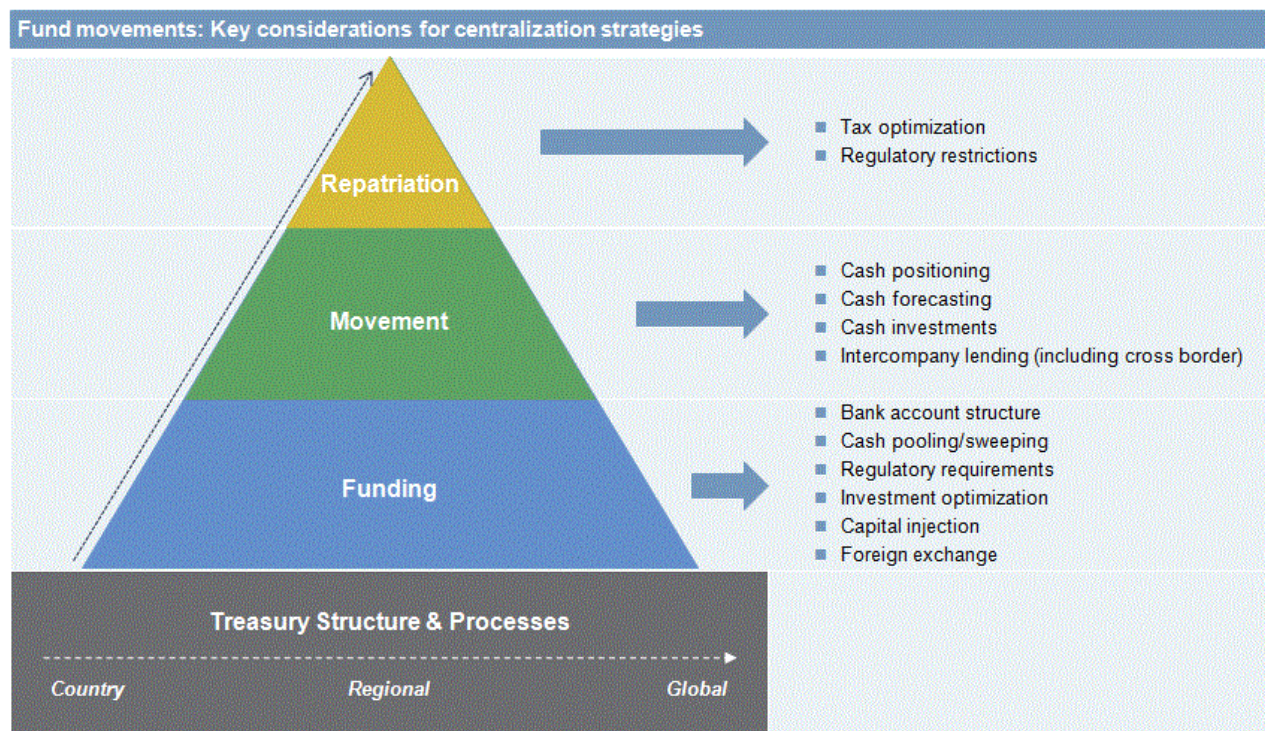
## Centralization of treasury activities in the insurance industry

Centralized treasury management is considered a key characteristic of world-class treasuries<sup>1</sup>, and is one of the top priorities of treasurers in the corporate sector. Treasuries in the insurance industry are also taking steps towards centralization, however the types of centralization activity that will realize benefits to the sector must be carefully considered against a background of regulatory, market and organizational factors. Cost efficiencies are a key driver behind the centralization trend, however the sector is increasingly finding that the risk management benefits (in particular, gaining visibility and control over their cash position) are a significant incentive for implementing centralization strategies.

## Key considerations for implementing regional and global centralization strategies

The insurance sector stretches across several groups: from primary insurers, to reinsurers, to the insurance brokers who manage dealings between end customers and insurance carriers. Each group has distinct characteristics and unique considerations. Even within the primary insurance sector, life and non-life companies have very different dynamics and are regulated in different ways. As a result, the benefits that

<sup>1</sup> The Hackett Group, 2009



different levels of centralization can offer will differ across the sector.

The geographical spread and flow of the organization's funds (including funding, movement of cash, and repatriation) are significant factors in determining the type of centralization activities that will realize benefits for the firm.

Of course, a completely centralized treasury is not always possible. As highly regulated entities, the insurance sector is subject to restrictions that can make it challenging to centralize operating cash across all entities. Regulators and rating agencies are increasingly looking at excess cash held at the local level in evaluating the capital adequacy of primary insurers and reinsurers. The credit rating of a subsidiary (and therefore the group's credit rating) is influenced by the subsidiary's excess cash holding. As a result, regulatory capital requirements may present a strong incentive for many primary insurers and reinsurers to maintain decentralized structures. In addition, local regulatory and tax requirements – particularly in the emerging markets – may also require cash to be held in country and prohibit the physical consolidation of cash into a central structure held at group level.

## Realizing the benefits of centralization: What types of centralization activities make strategic sense?

Taking into consideration the various regulatory, market and organizational factors, the insurance sector can still realize benefits from centralization by focusing on activities that provide the right returns within an appropriate framework.

## Gaining visibility and control over global liquidity

As a first step, many companies may be looking to gain visibility of their global cash positions and monitor daily intercompany cash movements by employing the use of electronic banking tools available from global banking providers. These solutions can provide a consolidated view of global positions and maturing investments across countries, currencies, legal entities and banking relationships. Advanced solutions offer flexible reporting functions for more informed decision-making and help companies to optimize internal cash by making it easy to manage intercompany loans and providing details of cash concentration structures. As part of the drive to enhance visibility, control and efficiencies, many

companies may also be looking at bank account reconciliation and investing in new technologies such as SWIFT, eBAM and upgraded Treasury Management Systems.

## Optimizing working capital: Centralizing the payables and receivables process

Like the corporate sector, many insurance treasuries are realizing the potential of effective working capital management and are increasingly seeking to standardize, automate and streamline the payables and receivables processes by leveraging best practices. This can result in significant cost savings, working capital release, maximized liquidity and improved customer and supplier relationships. From a strategic viewpoint, working capital metrics (for the insurance sector: days premiums outstanding and days claims outstanding) are increasingly being used by analysts to assess a company's efficiency.

Best practices in receivables management include higher levels of automation, improved reporting and reconciliation practices, leveraging electronic payments, and exploring direct channels for collections. Integrated receivables solutions can provide improved information flows, enhancing visibility and

providing tangible benefits including reduced costs and accelerated cash inflows.

Companies may also benefit from enhancing payables management. For example, primary and reinsurance companies can enhance claims disbursement processes by choosing an optimal payment method and centralizing the process. Best practices include minimizing check payments, using prepaid cards, increasing reliance on low value processing, selective use of wires for high value, urgent payments, and the standardization and automation of payments using a single payments provider. In addition to reduced costs, benefits of these strategies include increased control and enhanced visibility.

### Implementing regional treasury structures: Maximizing liquidity and increasing visibility, control and efficiencies

For companies with a large geographical spread, the centralization of treasury structures may provide substantial benefits which override the incentive to maintain decentralized operations. These types of structures may be particularly relevant to reinsurers and insurance brokers due to their tendency to have a large and growing geographical spread and substantial institutional flows.

Treasury restructuring, including the streamlining of global account structures, can provide group treasury with a platform for central oversight and control over local cash positions, as well as increasing operational efficiencies. The use of cash concentration structures can also maximize liquidity by enhancing the use of operating cash across entities.

Christof Nelischer, Group Treasurer of Willis, comments, "A treasury department should be open to rethinking structures and continually challenging itself by asking questions such as: 'How good is our department? How can we improve?' The regional banking solution we have put into place means that we can open new accounts in new locations with a consistent procedure – providing cost and time efficiencies, and giving group treasury insight into our global cash position."

Advanced treasury structures include the implementation of global and regional treasury centers, in-house banks, shared service centers and payment factories.

### Optimizing the use of trapped cash

Physical concentration structures may not always be feasible given regulatory and market incentives to maintain cash at the local level. In particular, companies who are operating in the emerging markets may find that local legal and regulatory requirements restrict the movement of cash. Cash might be trapped due to restrictions against the commingling of fiduciary and non-fiduciary funds, controls on cross border flows and repatriation, and limitations on intercompany lending. There may also be currency and tax controls which inhibit the ability to consolidate into a central structure.

There are several solutions provided by global banks to maximize liquidity in these circumstances ranging from interest optimization solutions, which take a portfolio view of cash accounts in multiple currencies, to specialized structures to maximize the use of cash trapped in the emerging markets.

## Choosing the right structures and solutions

There is an array of structures and solutions available to companies in the insurance sector that enable them to realize the benefits of centralization within the framework of their individual requirements. Companies may find substantial advantages in implementing regional banking solutions with a global partner bank, leveraging their regional and local knowledge in multiple markets. What is clear is that there is no "one size fits all" approach. Banking partners should have an advisory approach on industry best practices and optimal account and liquidity structures, and provide tailored solutions to increase visibility, control and efficiencies across the entire operation.

As the sector faces ever-increasing industry challenges, treasury is evolving into an increasingly strategic function and has a front-seat role in helping management to achieve its priorities. By implementing the right solutions and structures which provide group efficiencies, visibility and control, treasury is ideally placed to provide tangible benefits to the sector at a time when they need it most.