How to Help Your Board Members Fulfill Their Investment Responsibilities

What Are a Board Member's Investment Responsibilities?

Board Members for insurance companies carry numerous duties as part of their overall responsibilities for the insurer's investment operations:

- **To act with 'reasonable' skill and care**
  Dependent upon the board member's personal knowledge.

- **To take advice where appropriate**
  If not fluent with investments, board members should get proper advice unless the cost of advice is prohibitive relative to the size of the insurer. Any advice being truly considered should also carry a suitable level of risk and diversification.

- **To keep investments under review**
  Investments should be reviewed regularly by board members in conjunction with appointed advisors, as applicable.

Board Members must also include these key elements into their decision-making process as it relates to their investment responsibilities:

- **Suitability**
  Board Members must take into account the needs of the policyholders, the goals and objectives of the insurer, and type of existing investments. Board Members must also determine whether it would be more appropriate to invest in other investment classes.

- **Diversification**
  Board Members should be mindful of maintaining a spread of investments with a view to reducing the overall risk profile of the insurer.

- **Delegation, not abdication, of investment management functions**
  While board members may appoint a discretionary manager, the manager must act within a written investment policy statement, with board members periodically reviewing that statement. The manager should advise how they incorporate the Boards' adopted investment policy when the manager makes investment decisions or recommendations.

Given these considerations, it is important that board members understand their insurance company's investment process in order to correctly apply these elements and fulfill their overall investment responsibilities.

Overview:

Board Member Responsibilities
Typical Errors
Putting It All Together
Appendix

What are typical errors Board Members make?

Board Members are often unaware of investment decisions that could have provided an opportunity for improvement, but are never shown on your financial statements:

- Not considering **all possible asset classes or investments** within that asset class can result in lower investment income
- Not considering the possibility and the potential impact from a **more diversified portfolio** can result in lower portfolio investment returns, adjusted for risk.
- Not reviewing your insurer's **investment process periodically** can result in poorer investment results.
- Not reviewing **investment management fees** can result in lower investment income and returns.

What is Opportunity Cost?
The loss of potential gain from other alternatives when one alternative is chosen.

Another common error Board Members make is applying practices that are typical for personal investments, but are not applicable to an insurance company's investment process.

- Personal investment portfolios differ greatly from an insurer's, for example objectives, time horizon, constraints, and tax situation.
- Likewise, board members can also mistakenly apply investment practices they've seen for endowments, foundations, pension funds, etc. However, an insurer's practices greatly differ.
- Board Members should always consider enterprise risk factors specific to insurance companies when making investment decisions.

Finally, many Board Members do not receive investment advice from a true Fiduciary, which may result in actions that are not in the best interest of your insurance company.

What is a Fiduciary?
A fiduciary is legally and ethically held to ensuring any financial/investment services and expertise they provide your insurer is solely in the best interest of your organization.

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Key Considerations and Next Steps

Understanding Regulatory Constraints on Allowable Asset Classes:
Regulations can impose constraints on potential allocations to certain asset classes. Thus, a review of the applicable regulatory framework is an integral part of any asset allocation modeling.

Determining Risk Appetite:
Risk tolerance is vital to the strategic asset allocation process. The amount of risk an insurer is comfortable taking on within the portfolio will shape the overall investment program.

A short questionnaire to staff and Board members can help put some constraints around any asset allocation models being reviewed.

Most importantly, scenario-based impact analyses can be helpful in identifying and adopting an appropriate asset allocation framework.

Understanding Risk Tolerance:
Learn More >>

Review Current Asset Allocation and Potential Alternatives:
Insurers can compare their current asset allocation to other potential models in various ways. Potential asset allocation models can be focused on the asset side of the balance sheet or can also include the impact of reserves.

Many also model asset allocations by considering reserves, surplus, and other financial considerations. Because insurers already have leverage built into their financial statements, evaluating the additional leverage from investment allocation decisions is important to manage the enterprise risk.

It may also be beneficial to test how your portfolio may perform by simply changing the allocated amount to certain asset classes.

About Strategic Asset Alliance

SAA is an independent investment consulting firm that works exclusively with insurance companies and pooling organizations. Founded in 1994 by our President Alton Cogert, our experience and focus enables us to help our clients improve their investment process and enhance the value added by their portfolios which are critical components of their business.

We provide insurers and pools with independent investment consulting services to aid their board members and senior executives in meeting fiduciary responsibilities, along with strengthening their investment program.

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What is an Insurance Company's Investment Process?

For insurance companies to achieve strong investment results, a strong investment process is required.

The investment process goes beyond choosing the right investment manager and consists of these six components:

- **Allocate: Strategic Asset Allocation**
  Essentially, asset allocation is your insurer's investment strategy; the types and quantity of investments your insurer selected based on desired return, tolerable (potential) risk of loss and organization goals, and risk enterprise considerations.

- **Policy: Investment Policy & Guidelines**
  An investment policy clearly identifies an insurer's investment objectives and the role/restrictions of all parties involved in the process. The policy also helps prevent any problematic actions from happening.

- **Implement: Investment Manager Evaluation**
  Any third-parties managing your portfolio must also be aligned with your insurer from a philosophical and personnel perspective, not just performance.

- **Monitor: Portfolio Monitoring**
  Beyond monitoring what your manager(s) has been doing, it is important for insurers to track how the portfolio is acting in accordance with compliance, risk exposures, stress testing, etc.

- **Measure: Performance Analysis**
  Aside from reviewing your level of return, insurers should also analyze "why" their portfolio performed the way it did and adjust performance to the level of risks being taken.

- **Peer: Peer Group Analysis & Comparison**
  It is important for insurers to compare their portfolio to similar peers as a measure of performance and identify potential improvements.

Of course, each of these components consists of several requirements that board members should be mindful of (see Appendix). As mentioned previously, board members may utilize outside investment advice to ensure they are fulfilling their responsibilities to their organization. For those who utilize outside advice, it is important to understand if the party providing investment advice is a true fiduciary or not.

Investment Professional as a Fiduciary or Not?

Board Members can ask these simple questions to identify if the investment professional they are receiving advice from is a Fiduciary (or not):

- **Are they registered as an investment advisor with the SEC?**
  If "Yes," then they are a fiduciary

- **Are they a broker/dealer who is responsible for determining suitability of investments?**
  If "Yes," then they are NOT a fiduciary

- **Are they an Internal investment professional?**
  If "Yes," then they are probably not a fiduciary as they are held to standards of employment

- **If you are unsure, ASK this professional and get assurances in writing.**

What is a Fiduciary?
A fiduciary is legally and ethically held to ensuring any financial/investment services and expertise they provide your insurer is solely in the best interest of your organization.

Hidden Costs

Here are some hidden costs that your insurer may be subject to, but are often difficult to know without being advised to check for it.

- **Fixed Income Bonds have no trading commissions, but Stocks do.**

- **The cost of trading bonds is higher than trading stocks:**
  Stock trading commissions were deregulated in the 1970s and have since come down severely with the advent of electronic exchanges.

  Bond trading incurs bid/ask differences and is subject to a generally inefficient market (less so with US Treasuries).

  Some broker/dealers will buy a bond for their inventory and then sell the same bond to your insurer, potentially benefiting on the trade twice.

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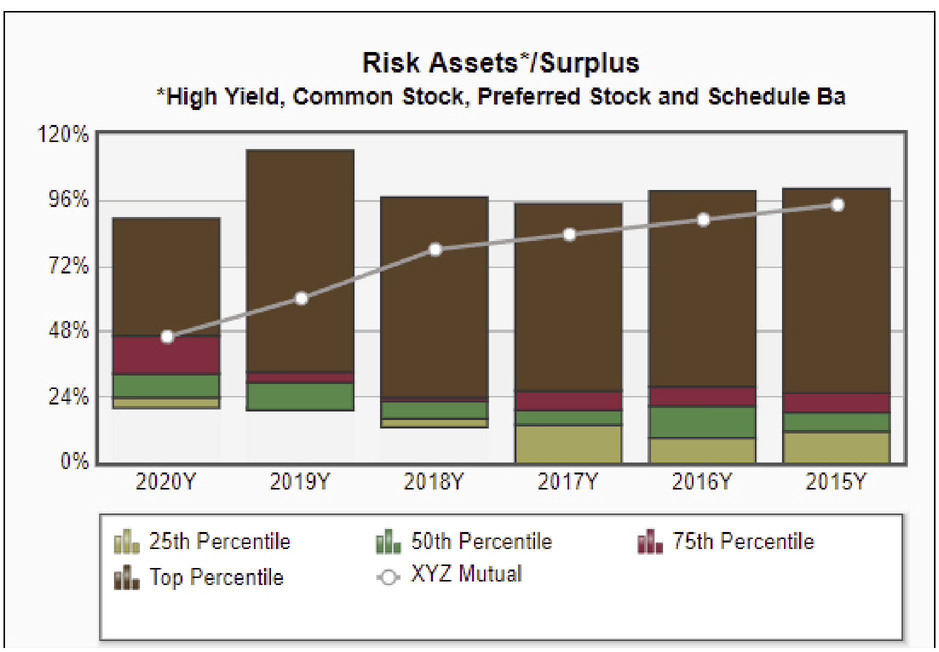
Risk Management of Investments

One key aspect of a board member's investment responsibilities is understanding where potential portfolio losses may come from and what level of investment risk the insurer is comfortable taking, including:

- **Risk Assets:**
  What is Our Risk Appetite Level? How Might Our Surplus Be Affected?

Risk Assets-to-Surplus Ratio	Net Assets/Surplus	Risk Assets	Risk Assets As % of Total Portfolio	Surplus Level ($): Worst negative return trend	Downside Impact: As % of Surplus	Surplus Level ($): Worst Calender Year Decline	Downside Impact: As % of Surplus
100%	$35MM	$35.0MM	43.80%	$17.8MM	-49.00%	$22.0MM	-37.00%
85%	$35MM	$29.8MM	37.20%	$20.4MM	-41.60%	$24.0MM	-31.40%
75%	$35MM	$26.2MM	32.80%	$22.1MM	-36.70%	$25.3MM	-27.70%
50%	$35MM	$17.5MM	21.90%	$26.4MM	-24.50%	$28.5MM	-18.50%
40%	$35MM	$14.0MM	17.50%	$28.1MM	-19.60%	$29.8MM	-14.80%
35%	$35MM	$12.2MM	15.20%	$29.0MM	-17.20%	$30.5MM	-12.90%
30%	$35MM	$10.5MM	13.10%	$29.9MM	-14.70%	$31.1MM	-11.10%
25%	$35MM	$8.8MM	11.00%	$30.7MM	-12.30%	$31.8MM	-9.30%
20%	$35MM	$7.0MM	8.80%	$31.6MM	-9.80%	$32.4MM	-7.40%
15%	$35MM	$5.2MM	6.50%	$32.4MM	-7.30%	$33.1MM	-5.60%
10%	$35MM	$3.5MM	4.40%	$33.3MM	-4.90%	$33.7MM	-3.70%
5%	$35MM	$1.8MM	2.20%	$34.1MM	-2.50%	$34.4MM	-1.90%

- **Diversification: SAA Sample Peer Analysis**



What Are Risk Assets?
Risk assets are any investment outside of investment-grade fixed income.

These assets provide greater potential yields, but with greater risk of loss and/or return volatility.

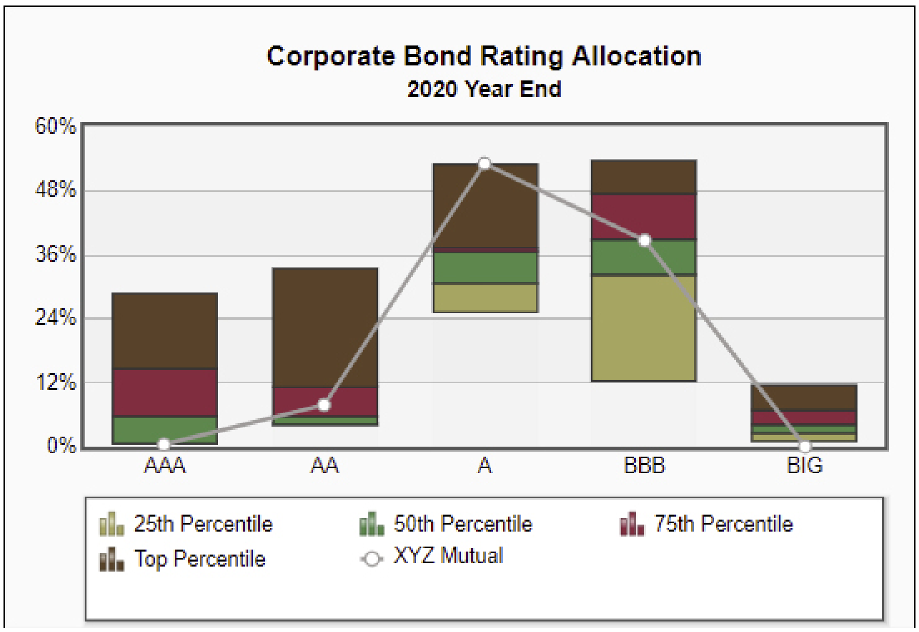
Portfolio Diversification?
Diversification is an investment strategy meant to mitigate various risks by utilizing various asset classes within a portfolio.

- **Fixed Income Duration vs. Duration of Reserves (Liabilities):**
  How sensitive is our bond portfolio to interest rates? How does that tie into our insurer's liabilities?

- **Credit Risk of Fixed Income Portfolio:**
  What is the credit quality of our overall fixed income portfolio? How comfortable are we with the current quality? Is our insurer comfortable reducing credit quality for higher, potential yields?

What Is Credit Risk?
The likelihood that the issuer of the bond could default on the committment and be unable to repay investors of the bond.

SAA Sample Peer Group - Corporate Bond Rating Allocation:



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Battling "Lower Rates for Longer"

Given the current environment, interest rates are expected to remain low for the foreseeable future. Thus, insurers will experience lower investment yield on their bond portfolio going forward. For board members, here are a few ideas when considering how your insurer might navigate this low interest rate environment:

- **Re-review Duration of Reserves (Liabilities):**
  Can we be rewarded by increasing investment portfolio duration? Is that worth the risk?

- **Review 'Risk Asset' Allocation:**
  Percentage of asset limitations are OK for investment policy purposes, but can be misleading

- **Determine 'Downside Risk' of a Given Risk Asset Allocation:**
  How does this compare with your insurance company's overall risk appetite?

- **Review Investment Benchmarks, Especially Fixed Income Benchmarks**
  Are they incenting the investment manager not to act in the best interests of your insurance company? How do they fit within a strategy of 'battling low rates for longer'

Putting It All Together - Initial Questions for Board Members to Ask

- Do your board members feel comfortable with the **depth** of their investment responsibilities? Do they still feel comfortable knowing they **can delegate, but not abdicate** those responsibilities?

- Have your insurer's board members considered **all parts** of the Investment Process in their deliberations about investments?

- Are your board members aware of both **hidden costs and opportunity costs** within the investment process? Those costs could be seriously **degrading the interests** of the organization.

- Are your board members comfortable with the **overall level of risk** within the investment portfolio? Are they familiar with and comfortable with the ongoing efforts to monitor and manage those risks?

- Are your board members comfortable with the **current level of portfolio monitoring, including performance measurement and comparisons to other insurance companies?**