



How to Help Your Board Members Fulfill Their Investment Responsibilities



STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

Introduction:

Given the growing concern over Board turnover within the insurance industry, we developed a primer to help Board Members understand and review their role within the insurer's investment operations.

This primer highlights a Board Member's investment responsibilities, as well as common errors. An Appendix can also be found in the complete primer (PDF) to further detail the key elements of an insurer's investment process.

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.

Overview:

Board Member Responsibilities
Typical Errors
Putting It All Together
Appendix

— What Are a Board Member’s Investment Responsibilities? *(Continued)*

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:

— 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.

What is Opportunity Cost?

The loss of potential gain from other alternatives when one alternative is chosen.

What are typical errors Board Members make? *(Continued)*

- 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.

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.

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.



Key Considerations & Next Steps *(Continued)*

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

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.



— Appendix

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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 consideration.

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.

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.



Measure: Performance Analysis

Aside from reviewing your level of return, insurers should also analyze "why" their portfolio performed the way it did and consider the level of risk 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.

Investment Professional as a Fiduciary or Not?

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.

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?