The Interview

Guest Q&A With

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Recovery from Crisis: Corporate Governance in Post GFC World[1]

IAUM: *Where do we stand with corporate governance 10 years after the GFC?*

POUTSIAKA: Many financial service participants have learned lessons about leverage, liquidity, counter-party risk, collateral, interdependence and *how quickly things that appear unshakable can collapse*. The GFC was unchartered waters that at times felt like being in Class 6 rapids with limited gear. In a matter of days, major companies went from being highly rated to being the vehicles for a liquidity crisis that threatened the system, requiring substantial government funding.

In the property and casualty insurance sector, state regulators and industry practices prevented serious dislocation, with the exception of certain mortgage and financial guarantee products (less than 2% of sector premium at the time) as reported by the GAO. And several steps have been taken since then. If the change in financial position of these insurers is a proxy for governance effectiveness, then it continues to work. Whether by choice or requirement, the industry is even stronger today.

Given their balance sheet strength, what ***is*** the central governance question at present for insurers? It is answering how their business strategy recognizes the structural changes underway. By no means am I suggesting we take solvency off the radar. Never. I'm confirming that *strategic business risk* has attained as prominent a place today, as *capital-market driven insolvency* had reached in the crisis.

"According to the PwC's 20th CEO Survey (2018), a higher percentage of insurance CEO's than those in any other industry are extremely concerned about the threats to their growth prospects from over-regulation, the speed of technological change, changing customer behavior, and competition from new market entrants. In short, the entire insurance business model is being disrupted….. At PwC's Financial Services Audit and Risk Committee Forum, 44% of insurance directors (in attendance) think that *most existing insurers will not survive, at least in their current form*."[2]

Simply put…following the GFC, the industry and regulators have built a stronger balance sheet for a business model that could be less relevant in the future. In the interim, the combination of significant capital to deploy and a mixed outlook for investment returns only intensifies the tension between underwriting/pricing discipline and growth, from a public shareholder's perspective. In companies where governance is performing at the highest level, a strategic response exploiting all these conditions is in motion, and the associated risks managed.

IAUM: *What are the operational elements of excellent investment governance for insurers?*

POUTSIAKA: This afternoon we'll talk about the ***operational*** determinants of governance success. I'll present my views in the context of the investment function and my board experiences more broadly. I believe these observations apply to all forms of governance.

With a former employer, indications of the challenge for me, as the new CIO, crystallized quickly. Changes were well underway which, along with all the "routine" moving parts of a risk-bearing company, shape a portfolio. We also saw this as the right time to build a more advanced process for strategic portfolio design.

The organization operated subsidiaries in multiple jurisdictions, each with its own

[1]Interview is expanded from PRMIA Conference Operational Risk & Due Diligence; Suffolk University Finance Department – Boston, MA; April 2018.
[2]https://www.pwc.com/us/en/industries/insurance/library/top-issues.html

set of investment needs. We determined that creating the position of regional CIO and forming regional advisory committees matched perfectly with these circumstances. While the committees did not have transaction authority, we chose to run them using a governance framework, and they did perform the heavy lifting for many of the risk and strategic recommendations made to the board of directors.

Through this approach, we could see which elements of governance worked best for us under a variety of circumstances. We acquired a rich data set in a compressed period. As we rolled out the program, we concluded that the effectiveness was a direct result of 5 aspects: (1) the design of the governance framework; (2) the clarity of goals and roles; (3) the degree of customization; (4) the selection of committee members; and (5) the level of committee engagement. In my ongoing discussions on this subject with executives, these same items find there way into most conversations.

IAUM: *How have investment governance models evolved?*

POUTSIAKA: We created a committee charter based on our collective experience at the time. It was more than adequate and, in some ways, innovative. But industry quality in this area has continued to improve, dramatically. One of my favorite source documents currently is a 2017 publication from the CFA Institute, *Elements of an Investment Policy Statement*. Templates like these identify the full scope of issues in a highly organized manner, including the mechanics of solid implementation Every company serious about investment governance should periodically audit how they measure up against a well-tested protocol, especially now, for many reasons:

- There is increased scrutiny of board accountability by rating agencies, regulators, analysts, shareholders, mutual policyholders, and the media. This focus has magnified the value of conducting an objective review periodically (and electively.)
- The GFC demonstrated, in stark terms, the significance of asset management to the financial health of intermediaries. Insurance companies have been expanding into new and sometimes riskier investments, as well as accepting weaker protective covenants, in response to lower embedded yields.
- Insurers are making greater use of highly-specialized external managers or consultants, itself a complex selection task with significant risk implications. Selecting the wrong manager for an investment-grade mandate is irritating. Choosing the wrong manager for middle-market bank loans can have much more serious consequences.
- Nothing short of a revolution is taking place in strategic portfolio construction for a variety of reasons, including ESG. Given the implications for risk control, a credible approval process needs to be in place.
- Expanding use of an Outsourced CIO model, while offering advantages to some companies, widens the fiduciary responsibility of an investment committee.

"Best practices" for investment governance are beneficial because they point you in the right direction. They are a great start, but not a great finish. This is where the other factors come into play.

IAUM: *Customization is key!*

POUTSIAKA: Our own lift-off point was that these were licensed p&c subsidiaries of a public company. But each painted a different picture based on their existing portfolio, financial and liquidity position, jurisdiction and regulations, underwritten lines, and business plans. In addition, they often had vastly different investment opportunity sets.

- In countries or regions with highly developed capital markets, like North America and Europe, we emphasized a thorough understanding of the relative value of all the choices.
- In emerging markets where bank paper and a few corporate issuers were the only options, we devoted more effort to credit and asset/liability challenges than to asset allocation.
- In Japan, our membership included deep foreign exchange expertise as we hedged this risk for long-duration returns imported to diversify out of the JGB dominated portfolio inherited through an acquisition.

The more we customized our governance approach – the people, the material, the process – the better the outcome in all respects.

IAUM: *What are the goals, and roles?*

POUTSIAKA: GOALS- The risk pillar of investment governance includes certainty around priorities. This means an unambiguous objective, precise constraints and limits, and the *most common error of omission*…rank ordering of other financial priorities that the portfolio manager should consider when making investment decisions.

The reason financial companies fall short in the objective setting phase is because it's complex.[3] There is a wide range of variables that come into play including form of ownership, access to and cost of capital, business volatility, accounting and tax regimes, etc. These sometimes conflicting interests is one reason I call this institutional segment the hot mess of asset management, and the future for other investors who recognize the value of considering all factors, the difficulty in doing so notwithstanding.

[3]See *Enterprise Driven Investing for Insurance Companies: The Hot Mess – and Future – of Asset Management;* https://www.gweiss.com/Insights/; May 2017.

The symptoms of poor objective setting are usually self-evident. It can manifest itself as an over-engineered model, a process that is entirely quantitative, or endless debates about the objective rather than how to achieve it. The CIO insists on total return over the long-term. The CRO argues for capital efficiency. The Chief Marketing Officer focuses on absolute yield. The CFO wants to realize capital gains for reported earnings, and the Head of Tax prefers taking capital losses to carry back and recover prior payments. Fortunately, our executives worked in harmony, and one of the many benefits was the clarity of the investment objective and risk limits, as well as the relative importance of other financial factors not directly captured in the objective's description.

A key and often forgotten task is the need for senior management to set skill-based and fully-aligned performance measurements at the same time they recommend an investment objective. This is a challenge when investment decisions are subject to many business considerations. In some respects, more skill is required under these circumstances. The playing field is smaller, but it's of paramount importance to evaluate the skill of the team you've assembled, for several reasons including compensation. There are ways to gauge this skill in highly constrained mandates, such as strategic performance against a customized model portfolio, and asset class carve-outs unconstrained by the business.

ROLES- Clarity and organization-wide understanding surrounding roles, authorities and their linkage in a fully integrated investment process, is also a necessity. This defines compliance, and prevents risks and opportunities from falling through the cracks. However, the larger benefit – the elephant in the governance room -- may be that when this clarity forms a bright line between a committee and day-to-day management, executives should be less concerned over loss of control. As a result, management should welcome knowledge experts to the investment committee or a separate advisory board.

IAUM: *Who should be selected for governance?*

POUTSIAKA: I have always found that boards and committees having domain expertise and critical thinking were the most effective, and failed to understand how a basic governance threshold is possible without them, even when excellent reporting and an otherwise terrific governance model are in place.

The expertise of an insurer's investment committee needs to be diverse and relevant to the portfolio framework envisioned. Member selection criteria should also include critical thinking, not just going along with the Committee Chair. High caliber candidates look for an opportunity to have an impact *(within the committee's mission)* and to learn from respected specialists in other areas. Diversification of investment expertise, and critical thinking, create these opportunities and attract the right members. The presence of these attributes is best revealed by the quality of questions. In governance, a good question is more important than a good answer. Here are two examples.

An external fixed-income manager was presenting an impressive performance record against a benchmark. A committee member with prior experience asked two questions: (1) How much of the excess return (and risk) was attributable to securities not in the benchmark, and (2) with these securities removed, what was the tracking error? These questions were designed to reveal indexing (through sampling) and excess return having little to do with the benchmark. In addition to sending the wrong signal on a manager's security selection skill, sparse reporting of this type can seriously undermine asset allocation strategy if not violate investment guidelines. These questions elevated our performance evaluation and attribution analysis elsewhere as well.

In another instance, we were evaluating a strategic rebalancing for one of our portfolios. The primary objective was net investment income, but the rebalancing was motivated by potential improvements in secondary, but important, measures. The committee first elected to maintain net investment under all circumstances, when a member posed the question…"What will this cost?" Analysis showed that a de minimis reduction of 5-10 basis points in NII allowed for substantial benefits in overall return, diversification, and risk-adjusted contribution at the portfolio level. Critical thinking had increased our understanding significantly.

IAUM: *How do you achieve committee engagement?*

POUTSIAKA: By definition, membership on an investment committee is a critical role and participation should be interesting but, in the latter case, often falls short. A concerted effort in three areas will position committee members to maximize their engagement.

PERFORMANCE EVALUATION.
Everyone fortunate enough to be given governance responsibility, whether by appointment or election, should be the kind of person motivated by their own high standards. But this is a dynamic process with many twists and turns unique to an organization. It is critical to give the governance team a road map for how things can be adjusted to maximize their effectiveness. We did an annual assessment at the individual and group level, to guide these ongoing improvements.

COMMUNICATION.
This means several things.

Availability of Information. We made committee material available in advance, then distributed minutes and action items

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on a timely basis afterwards. Information was posted on an intranet-repository for all regional committees and others throughout the company approved for access. Being customized did not mean ideas weren't transferable. We shared.

Quality of Information. This starts with a thoughtful selection and presentation of Standing Agenda items. But every governance committee should also have a schedule of Special Topics that amounts to a self-imposed challenge to look for emerging trends, rather than just being reactive. These discussions can include external experts. Today's subjects could include the following:

- Given all the invention in Smart Beta, ETF's, etc. what is the best market taxonomy for strategic and tactical allocation, including risk factors?
- Investors are making sizable commitments to less liquid private markets. How should they properly value the illiquidity premium attached to different strategies or layers of the capital structure?
- Do advances in technology impacting the front-, middle-, and back-offices make a company's current insourcing/outsourcing strategy less relevant?

Format of Information. Committee members are often buried with low-value and stale information, often masking the main issues and failing to recognize the Committee's role. Just because improvements in data and technology make it easy to produce more tables, doesn't mean it's helpful to do so.

Our material usually included a summary of the detail provided for each topic. We also used visual analytics…. a fascinating communication discipline that presents complex matters in simpler ways, requiring less explanation. This was especially helpful with decisions regarding the multiple trade-offs associated with managing balance sheets.

Here's my acid test for material…A business professional without organizational familiarity should be able to pick up a quarterly investment report and within 25 minutes understand, clearly, four basics: (1) risk limits; (2) how well you have done (or not) against the primary objective; (3) the decisions made that had the biggest impact on value, including the reasoning; and (4) your recommendations and the basis for them. For an investment professional without knowledge of the entity, this should take 15 minutes, and a seasoned committee member, 10 minutes.

MEETING DYNAMICS.
We always favored more discussion and less presentation based on the expectation that members had reviewed all information thoroughly. In addition, by including a thoughtful question where appropriate, we centered the meeting discussion and helped members prepare as they read material with this question in mind.

We also cultivated debate as a form of quality control. There are many ways to achieve this dialogue. We sometimes used voting technology to stimulate different views mid-way through a discussion that was feeling like group-think. Often, this "cultivation" wasn't needed to foster debate. These were spirited meetings, but they showcased professionalism, mutual respect and full support for decisions. Collectively, these characteristics are the hallmark of excellent governance chemistry.

IAUM: *So in conclusion, a more robust expectation for the value of investment governance?*

POUTSIAKA: There are no guarantees with governance. Companies sometimes can, and often do, take a narrow and procedural view. It's relatively easy to check the box with a perfunctory process. This was acceptable in the past for many insurers, even preferred by some. Wait out a soft pricing cycle, or for asset impairments to recover on their own, etc. Given today's industry challenges, a passive approach like this is especially dangerous. At the other end of the spectrum are massive and bureaucratic governance programs that add little value.

Alternatively, simple and well-designed governance has no less potential to contribute than any other dimension of the organizational challenge, while firmly respecting the distinction from management The approach to investment governance I've outlined today had a very positive impact on controlling risk, enhancing returns and engendering confidence with internal and external constituents. While the companies involved had met their obligations through the crisis, the changes implemented in management oversight, using a governance model because of the size and complexity of the enterprise, realized these additional benefits. The changes were endorsed and shaped by their respective boards, which demonstrated a keen recognition of the full potential in a strong investment governance philosophy. The wisdom of doing so was evidenced in the favorable outcome, including professional fulfillment for all involved.

About Our Guest

Bill Poutsiaka is a senior financial services executive with considerable experience as CEO, CIO and board member for global insurance and asset management businesses. He is currently consulting, doing board work, research, publishing and speaking at conferences.

Bill has served as an active director on the boards of public, private and non-profit organizations. His executive roles have included SVP & Chief Investment Officer of AIG Property Casualty following the financial crisis; CEO PanAgora Asset Management, and CEO Arkwright Mutual Insurance Co. (predecessor to FM Global).

He began his career in the investment department of the Liberty Mutual Insurance Co. Bill received a B.A. from Muhlenberg College and an M.B.A. from Boston College.