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Women in *Insurance* LEADERSHIP 2019

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INTERVIEW

Neeti Bhalla Johnson
Executive Vice President & Chief Investment Officer,
Liberty Mutual Insurance

Thought Leadership for the Insurance Investment Community

Investment Governance: What Is It Good For?

JJG Advisory

Absolutely everything! Say it again!

John J. Gauthier
Principal of JJG Advisory

Mr. Gauthier is the former CIO of Allied World Assurance and currently sits on the Board of Reinsurance Group of America. His colleagues Anne Melissa Dowling and Bill Poutsiaka, also have extensive and successful experience in managing insurance company portfolios. Their bio's can be found at www.JJGAdvisory.com

In the field of investment management there are few topics more sobering than the topic of governance. That's especially true in insurance company investment management, where governance ranks near statutory accounting for most interesting topics. But that is no longer true for organizations looking ahead....the landscape is changing in unprecedented ways that elevate, dramatically, the importance of investment governance. These changes include new investments, business models, technologies, greater risk-taking, and heightened expectations for governance by regulators. For U.S. based insurers, this will become extremely relevant with the implementation of NAIC's Corporate Governance Annual Disclosure Model Act and Regulation, which becomes effective 1/1/2020. Checking the box with a perfunctory process is no longer acceptable for investment governance at insurance companies.

Having spent years managing portfolios for insurance companies; both from the outside and then from within, Anne Melissa Dowling, Bill Poutsiaka and I have dealt with all kinds or governance frameworks, investment policies, delegated authorities and investment guidelines. In my last CIO role, I spent the first six months working with board members on updating the Investment Committee Charter, the Investment Policy Statement, and determining who was responsible for every decision in the portfolio. It didn't mean that we always generated great returns, but it did mean that we couldn't blame any of the results on "the system".

When we embarked on our consulting endeavor, Anne Melissa, Bill and I all felt deeply that governance was a place where a. there was a need, and b. we could fill that need. We determined that we'd focus on helping insurers improve "HOW" they make investments decisions, not "WHAT" they currently invest in. The overriding goal is to make sure there is clarity and consistency of the insurer's goals, objectives and risk tolerance as it pertains to the investment portfolio, and how that portfolio fits into the overall insurance enterprise. Based on our collective experience, we firmly believe that an improved governance framework can improve investment results AND allow companies to better articulate their investment decision-making process to shareholders, policyholders, analysts, regulators and rating agencies.

THE INSURANCE INVESTMENT GOVERNANCE DIAGNOSTIC FOCUSES ON SIX KEY AREAS.

First, is the overall Governance Framework. This includes a review of the Investment Committee Charter, Investment Policy, investment goals and objectives, risk tolerances, limits and constraints, committee membership, committee evaluation, organizational context, implementation plan. The review is designed to achieve organizational consistency, tailoring and clarity of objectives, risk tolerances and other constraints at every level of investment decision making. It includes a full review of previous committee minutes, the review of numerous internal (investment policy, investment guidelines) and external (rating agency and regulator disclosures, supplemental filings) documents.

The second step is reviewing the delegation of authorities and responsibilities (including external contributors) in the investment process. There are literally dozens of decisions that get made in an insurance investment portfolio; from long-term strategic asset allocation to the purchase or sale of an individual cusip. Having clarity on who is responsible for what decision allows for decisions to be made faster and by the most effective person. There is nothing worse than having a specific view on the market, being correct on that view, and not having acted upon it due to uncertainty

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around delegated authority. Think about the analyst who has a view of credit deterioration on a specific issuer or sector. She thinks it's not within her authority to sell the bond(s) and they trade down materially. Obviously, having that clarity would have benefited the portfolio returns. Similarly, does it make sense for an Investment Committee meeting quarterly to reset portfolio weights for separate small-cap value and growth sleeves, or should it set risk premia weights, leaving sector and security selection to managers who track intra-premia exposures for a living?

The third area of appropriate governance is enacting best practices around the investment committee. Who sits on the committee and whether they have relevant qualities is a key first step. These qualities include critical thinking (evidenced by excellent questions) and the type of investment domain expertise most important to a particular company. But the committee also must have a clear agenda, must ensure they are being continually educated on relevant investment topics, and must work to ensure the topics on the agenda are supportive of the company's investment goals and objectives. Market opportunities come and go, and the committee must be up to speed on those opportunities in order to take advantage of them. Unless a committee is up to speed on Emerging Market Debt (to choose as an example) it is unlikely to approve an allocation, or to sell an allocation, at the appropriate time in the market. There should also be a standing agenda item that anticipates emerging issues of all types, such as private market opportunities, AI, and new models for outsourcing. Finally, the full potential of all this talent and material should be realized with a meeting process that fully engages all participants.

The fourth critical area pertains to portfolio rebalancing. Even if the overall investment goals are clear and consistent, authorities are appropriately delegated and the investment committee uses best practices, the process of making tactical shifts in the portfolio should be clearly outlined in advance. It should be clear who is involved in the decision, the models used and inputs required (economic news, market data, risk constraints, etc.) and the process by which the decisions are made (sole vote, majority, unanimous, etc.). Additionally, there should be detailed notes taken as to why decisions are made, and there should be a review of the previous decisions made to determine how good the people are at making such decisions. Obviously, the policy and delegated authorities should make clear the level of change permitted, but the group in charge of making those changes should also have clarity of process.

In addition to clarifying all of the above, the portfolio needs to fit into the overall risk management framework; both within the portfolio and through a process that recognizes/prioritizes all variables important to the enterprise, investment and otherwise. It is critical that the investment portfolio have clear risk limits; whether there is one limit or multiple limits. It needs to be clear on what is the "binding constraint". Those risk limits need to be clearly articulated to anyone involved in the investment function. It must also be clear what the team needs to communicate regarding those risk levels and what should be done as they get close to those limits. Breaching investment risk limits can have negative consequences to the credibility of the folks involved in the process. Having all of the risk limits and communication processes outlined in advance can be quite helpful to all involved.

Last but not least, performance measurement and compensation ties it all together. It may seem self-evident, but the way a company compensates their investment professionals should be tied to the investment goals and objectives of the company. There are a lot of ways to do this: it can be based on investment income or total return. The total return can be based on reaching an absolute level, or a level relative to something else. The something else can be a peer group or a market benchmark or both. And they can be paid on short term returns or over a longer-term time frame. Lastly, there should be some consistency between how investment professionals are paid and what is disclosed publicly to shareholders. There is certainly no "one size fits all" approach to measuring and compensating investment professionals, but doing so appropriately can be critical in keeping your investment team focused on meeting the company's goals.

When all six tenets are optimized, there is likely to be better returns on the portfolio and better articulation of those returns for internal and external constituents. There is little downside and meaningful upside to optimizing insurance investment governance.

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