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Personnel Risk Faced by the Insurance Industry

True or False Questions — Submit Answers Online

1. In the Finance and Insurance Industry the number of employees hired is only slightly lower than the number of separations over the last ten years.

   a. True
   b. False

2. The Finance and Insurance Industries continue to experience an increase in cost of compensation for employees due to the need to retrain the existing workforce, the increase in the cost of healthcare, and other factors.

   a. True
   b. False

3. The Finance and Insurance Industry is experiencing a gradual increase in average job openings.

   a. True
   b. False

4. It is helpful to have a copy of the current organizational chart to compare to the one used in the prior exam to gain an understanding on changes in personnel and/or overall organization.

   a. True
   b. False

5. There are few reliable sources to monitor overall job trends for the insurance industry.

   a. True
   b. False

Market Briefing 3Q2020: A Second Half Story Begins

True or False Questions — Submit Answers Online

6. While the investments of insurers are normally actively managed, the turnover ratio for invested assets of life insurers is around 20%.

    a. True
    b. False

7. As compared to 2018, L&H insurers increased their common stock ownership in 2019 by almost $85B, based on a strong equity market in 2019.

    a. True
    b. False

8. The majority of bonds owned by US insurers are the more conservative government bond, which remain a mainstay of US insurers.

    a. True
    b. False

9. Longer term bonds, which may be used to get a little more interest in a low interest rate environment, experience more value volatility with changes in interest.

    a. True
    b. False

10. Insurers have been investing less in commercial real estate, with the steady increases in the equity markets, so that there has been less exposure to volatility in real estate valuations.

    a. True
    b. False

Boardroom Advice for Handling Disruptive Risk

Multiple Choice and True or False Questions — Submit Answers Online

11. Disruptive risk has long been discussed as a separate risk category and traditional ERM models emphasized disruptive risks and their capabilities.

    a. True
    b. False

12. The Committee of Sponsoring Organizations of the Treadway Commission (COSO), the National Association of Corporate Directors (NACD), and other bodies that provide guidance on risk management have focused on ____________ involvement in managing disruptive risk.

    a. Management
    b. Board
    c. All Employees
    d. Shareholders

13. Which of the following is not a suggestion on how to improve board risk oversight of disruptive risk?

    a. Question legacy business models
    b. Watch for external Risks
    c. Maintain rigid governance that limits board member involvement
    d. Identify trigger and interconnected risks

14. In order to demonstrate a robust assessment of a Company's emerging risks, the Board should confirm through the annual report:

    a. That the risk assessment has been completed; describe the risks
    b. What procedures are in place to identify emerging risks
    c. Provide an explanation of how these risks are being managed or mitigated
    d. All of the above

15. Boards should invest in the skills – within the organization and on the board itself– needed to navigate disruptive risks.

    a. True
    b. False

NAIC 2020 Summer National Meeting Notes

Multiple Choice and True and False Questions — Submit Answers Online

16. The NAIC Statutory Accounting Principles Working group adopted INT 20-08T – COVID-19 Premium Refunds, Limited Time Exception, Rate Reductions and Policyholder Dividends as a temporary interpretation to sunset on January 1, 2021.

    a. True
    b. False

17. The NAIC Statutory Accounting Principles Working Group adopted the following revisions to SSAP 32R – Preferred Stock, except for ____:

    a. Revises the definitions of redeemable and perpetual preferred stock
    b. Adds a definition and guidance for mandatory convertible preferred stock
    c. Requires that all preferred stock be non-admitted
    d. Clarifies elements of the OTTI assessment for redeemable preferred stock

18. Many workers deemed "essential" who have exposed themselves to the virus (e.g. grocery store clerks), will have a very simple standard to prove that COVID-19 is a compensable occupational disease under workers' compensation state laws.

    a. INT 20-02T - Extension of Ninety-Day Rule for the Impact of COVID-19
    b. INT 20-04T - Mortgage Loan Impairment Assessment Due to COVID-19
    c. INT 20-05T - Investment Income Due and Accrued for Impact of COVID-19
    d. All of the above

19. The NAIC Reinsurance (E) Task Force reported that the 2019 Revisions to Credit for Reinsurance Model Law # 785 and Model Regulation # 786 are scheduled to become accreditation standards by 2022.

    a. True
    b. False

20. The NAIC CIPR Special Session on Race and Insurance panelists discussed the all of the following solutions to promote diversity and inclusion in the insurance industry, except for ___:

    a. Detecting discriminatory practices by collecting market conduct regulation data in the same robust manner as that used for financial regulation
    b. Improving consumer education on insurance policies and coverage
    c. Ensuring equity in healthcare coverages by preventing unfair differences in healthcare coverage
    d. All of the above

Personnel Risk Faced by the Insurance Industry

By Sara Jean Schumacher
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The insurance industry is not immune to personnel risk. With an ever-changing and volatile job market, coupled with rapid technological advancements and other factors, most notably COVID-19, this risk is becoming more prevalent and cannot be ignored as part of current regulatory examinations. Personnel risks can be different for each company depending on various factors such as type of insurance written, business model, local job market and upcoming changes for the company.

While many personnel risks may not be viewed as traditional solvency concerns, it is essential for management, examiners and analysts to be aware of how these risks could adversely impact a company. Examiners should take this risk into consideration when reviewing areas such as corporate governance, fraud, segregation of duties or other internal controls and identification of key functional activities. If pervasive throughout an organization, the examiner may need to increase the overall risk profile.

This article will provide an overview of the job outlook for the insurance industry. In addition, the article will discuss some best practices to assist examiners and analysts in the identification and assessment of the specific personnel risks being faced for the company under surveillance. Based on this job outlook and other factors, the article will present some personnel risks examiners and analysts should consider during future examinations and/or when updating their branded risk assessments.

Job Outlook for Insurance Industry Prior to the Impact of COVID-19 – Great for Employees, Not So Easy to Manage

The following highlight several job outlook trends prior to COVID-19:

Availability of Experienced Workers

Insurance companies continue to experience difficulties filling job openings with experienced personnel. This can occur at all levels (not just Executive Management) and within any department at an insurance company.

- Per the first quarter 2020 iteration of the Semi-Annual US Insurance Labor Outlook Study, "the insurance industry remains in a candidate driven market with a nearly non-existent unemployment rate."
- The Finance and Insurance Industry has been continuing to increase its workforce. This is evidenced by various statistics from the United States Bureau of Labor and Statistics:
  - The continued increase in the average job openings from 108,000 in 2009 to 261,000 in 2019.
  - The increase in the number of employees in the Finance and Insurance Industry from about 5.76 million employees at the end of 2009 to about 6.46 million employees at the end of 2019.
- The Finance and Insurance Industry continues to lose a significant number of employees each year as individuals from the baby boomer

generation retire. This results in the industry running into difficulties with being able to replace experienced personnel not to mention the loss of historical knowledge as many of these individuals were with the company for decades. For instance, the number of employees hired over the last ten years in the Finance and Insurance Industry is only slightly higher than the number of separations over the last ten years, which was about 1,371,000 hires versus about 1,340,000 separations (The United States Bureau of Labor and Statistics).

- In addition, the availability of experienced workers can be impacted by position growth & decline and the implementation of new technology and/or other strategic changes.

Position Growth and Decline
Insurance companies may experience difficulty filling certain positions given projected growth by 2028 or may need to consider reorganization of their personnel given projected decline in some positions by 2028. The average projected employment growth rate is about 5-6% by 2028. Below is a summary of some positions on the rise and decline by 2028 per The United States Bureau of Labor and Statistics:

- The most significant growth will be Information Technology positions. Some of the top growing occupations by growth rate include:
    - ◆ Information Security Analysts 32%
    - ◆ Software Developers/Applications 26%
    - ◆ Computer and Information Research Scientists 16%
    - ◆ Web Developers 13%
    - ◆ Computer and Information Systems Managers 11%
    - ◆ Computer Support Specialists 10%
    - ◆ Computer System Analysts and Database Administrators 9%
- Market Research Analysts 20%
- Financial Managers 16%
- Insurance Sales Agents 10%
- Financial Examiners 7%
- Accountants, Auditors, and Financial Analysts 6%
- Insurance Underwriters 5% decline
- Claims Adjustors, Appraisers, Examiners and Investigators 6% decline

Implementation of New Technology and/or Other Strategic Changes
Insurance companies continue to adopt new technology, replace legacy systems and/or change their strategic plans. This is done for a variety of reasons to ensure, among other things, policyholder and/or shareholder expectations are met, to remain competitive, adapt to business disruptors or other reasons. These changes can influence an insurance company's personnel differently such as:

- There could be a need for a new skill set or experience not only to implement the new technology, but to operate the technology, to complete maintenance and/or to make updates.

- Many times, companies may also need to retain individuals that can run out business on their legacy system, which requires personnel to ensure these legacy systems are maintained until fully obsolete.
- Certain positions or duties could become obsolete as technology is now performing these functions and/or the function is no longer necessary. Examples could be big data and/or artificial intelligence that can perform these functions such as the completion of reconciliations, automating the underwriting process, and/or identification of potential fraud.
- The organization may need to be re-organized to suit the new strategic plan. Many companies are adapting to new generation of consumers' demands, not to mention the impact of COVID-19. One such example is the implementation of mobile apps to be used by the customer. The banking industry was one of the first to implement this option so individuals with past experience on this implementation were recruited heavily by some insurance companies when implementing these mobile applications for their company.

Increase in Labor Costs

The Finance and Insurance Industries continue to experience an increase in cost of compensation for employees due to the need to compete for experienced workers, the increase in the cost of healthcare, and other factors. The United States Bureau of Labor and Statistics estimates the cost of total compensation per hour worked has increased from $39.19 at the beginning of 2009 to $54.48 by the end of 2019 or about 39% over the last ten years. This is expected to continue given projected increase in costs for employer healthcare on average is expected to grow 6% in 2020 and increases in order to compete for certain positions.

Job Outlook post COVID-19 – Uncertainty but Instable

Much like the rest of the industries, insurance is not immune to the impact of the coronavirus. While many of the previously discussed personnel outlook trends will likely continue, there is also much uncertainty as the insurance industry will need to respond to the impact of the COVID-19 over the next couple of years due to declines in premiums, rises in costs, changes in regulations, economic changes and other factors. The following is a brief update on the Job Outlook for the Finance and Insurance Industry at this time. The outlook is likely to change as the impact of COVID-19 continues to disrupt the Insurance Industry and may be more or less applicable depending on lines of business being written.

Per the Third Quarter US 2020 Semi-Annual US Insurance Labor Market Outlook Study, the initial results are the insurance industry has remained relatively stable in the insurance labor trends during COVID-19. The recent study released indicates about 48% of companies anticipate increasing employees, 35% of companies expect to maintain employees and 17% anticipate decreasing employees. Insurance companies anticipate offering flexible work options even once offices re-open which includes increased ability to work from home, flexible hours and full-time remote.

There are reports estimating eight of eleven functions have experienced increased difficulty in recruitment, especially Actuarial, Technology and Analytic positions. Respondents indicated:

- Technology and analytics roles are expected to grow the most.
- There is a need for Underwriting Executive talent.
- Entry level positions are anticipated in operations and actuarial areas.
- There is likelihood of under-staffing given anticipated increases in business volume.

The Second Quarter US 2020 Semi-Annual US Insurance Labor Market Outlook Study had a mixed bag of results as some companies were hiring, some companies were still evaluating their hiring plans, some initiated hiring freezes and some companies were slowing hiring due to COVID-19 but no significant layoffs were noted. The companies noted plans to add full time technology, analytics and claims personnel but also plans to use temporary staffing during the pandemic. The increased in claims staff was not unexpected given increase claims for certain lines of business.

While rumors abound about potential layoffs, furloughs, and cuts in compensation for companies, the only insurance company in the news so far seems to be Aon, PLC (Aon). There has been several announcements regarding changes in Executive Officers and Directors.

- In April 2020, "Aon announced it will temporarily cut the pay by 50% of the company's named executive officers in response to the COVID-19 crisis. In addition, 70% of its global workforce will see a 20% reduction in their salaries, while approximately 30% of Aon colleagues will see no reduction" (Howard).
- Effective July 1, 2020, Aon reversed the decision and will pay in full any reductions to salary for its employees plus 5% of the withheld amount. The reductions remained in place for executive offers and board members in addition to some other cost cutting initiatives (Nadeem).

The Finance and Insurance Industry is experiencing fluctuations as 2020 continues and is evidenced by various statistics from the United States Bureau of Labor and Statistics such as:

- The gradual decrease in the average job openings from 231,000 at the end of 2019 to 345,000 in January 2020, 289,000 in February 2020, 246,000 in March 2020, 210,000 in April 2020, and 185,000 in May 2020. There was a preliminary estimate of an increase in 217,000 job openings in June 2020.

- The number of employees in the Finance and Insurance Industry is staying pretty stagnate as was about 6.46 million employees at the end of 2019 to ranging from 6.44 million to 6.55 million in 2020.
- The unemployment rate was 2.0% for experienced finance and insurance personnel at the end of 2019 and has averaged about 2.8% in 2020 ranging from low of 1.8% to high of 3.8%. The unemployment rate for August 2020 is 3.1%.
- The estimate for new hires in June 2020 was 158,000 which was up about 10,000 from average for June the prior ten years. The beginning half of 2020 was marked by new hires for each month exceeding the average for the prior ten years apart from May 2020.
- The average number of separations was above the average for the prior ten years for January to March 2020 and was below average for April to June of 2020.

As other industries let personnel go, opportunities may present themselves for insurance to acquire this talent. These individuals may likely need to gain more knowledge and/or experience specific to insurance, however it may be a gain due to their past specialized experience or skills transferring over (i.e. IT, finance, investments, etc.).

How to Identify Specific Personnel Risks and Stay up to Date on Insurance Personnel Trends

Examiners and analysts should assess the risk that is appropriate for the Company and the Industry overall. Following are some best practices to help identify personnel risks and risk mitigation strategies.

C-Level Interviews and/or Discussions with Management

One of the best approaches to identify potential personnel risks specific to a company is through C-level interviews. In formal and informal discussions, management is in my experience usually pretty forthcoming with state departments on open positions, personnel risks, and personnel plans. Many times, a transparent relationship between company management and department personnel, leads to greater transfer of information that may not fully be known internally and/or to the public.

Examiners and analysts should not be afraid to ask frank questions about open positions, need for certain experience or skill sets, succession planning, hiring issues or training initiatives. In past examinations, this has allowed for prospective risks to be more specific to a company and for examinations to focus on key areas or risks that may be significantly impacted due to individuals performing dual roles, significant turnover in an area or other factors.

As an example from a recent exam I worked on, there were several late and/or inaccurate filings by a company. Once the issues were discussed with different members of management and personnel, it was determined that the cause was likely due to significant turnover in key areas like accounting along with changes in responsibilities between departments. Past personnel had been with the company for decades and responsibilities of each employee were not always clearly defined in writing. As a result, the new personnel did not know the extent of their duties and responsibilities resulting in certain required filings not being completed timely and/or accurately. It took time to train the new employees to the full extent of responsibilities and required an examination to determine the overall reason for the issue. Once the reason and overall issue was fully known, the company implemented a filing checklist to ensure everyone knew the individual/position responsible for each filing and then set up reminders to ensure timely review and submission.

Strategic Plans

Personnel risk can change in concert with strategic plans. Be cognizant of new strategic initiatives and personnel resources required to achieve them.

The recent move by the insurance industry to implement new technology and/or to offer digital options for agents, policyholders, claimants or others has resulted in an increased need for IT personnel with specific experience either in implementation and/or upkeep. It can also result in restructuring and/or terminations as some positions may become obsolete resulting in re-training of employees to work in different positions or to take on different responsibilities.

Another trend that is likely not to change any time soon is employees working from home. Many companies are reporting plans to continue remote work even after COVID-19 either on a permanent basis, temporary basis and/or as part of the business continuity and/or disaster plan. The impact of increased personnel working from home likely could result in a whole article all on its own given:

- The new risks faced for the company by working remotely;
- The increased risk assessment for certain branded risks areas;
- The increased need to be able to troubleshoot tech issues remotely;
- The increased need to electronically communicate through phone or teleconference (i.e. virtual conferencing);
- The increased potential for fraud, privacy compliance, data security and cybersecurity concerns and;
- The potential impact on internal controls in addition to how to test/ monitor that internal controls are working as designed and effectively.

Given the recent trial by fire as a result of COVID-19, examiners and analysts can likely gain an understanding of what worked well, what issues arose and what changes a company may be making before transitioning from a “temporary” work from home model to the new long term strategic plan for working from home option for employees. This likely could be one of the many COVID-19 topics/questions examiners and analysts can include in the

C-Level Interviews. For examinations, this could impact the areas of focus and/or identification of specific risks especially surrounding the IT Review, internal control testing/walkthroughs, fraud factors to address, market conduct concerns and other aspects.

Organization Charts, Risk Repository, Budget and Other Filings
As a best practice, it is helpful to have a copy of the current organizational chart to compare to the one used in the prior exam to gain an understanding on changes in personnel and/or overall organization. Many times, the current organization charts will provide information such as vacant positions and dual positions held. When comparing the two charts, examiners can get a true feel for the amount of turnover and/or changes in the organization structure.

Companies usually only report turnover in executive management and/or the Board of Directors in Exhibit B or Exam Planning Questionnaire and/or notification of changes to the state departments. This sometimes results in examiners and analysts not being fully aware that the underwriting department fully changed since the last exam so then may want to focus some more attention to this area in Phase 1 to determine if there is a need to include specific risks and/or maybe raise risk assessment for underwriting key risk area.

In the past, it has been beneficial to have a copy of the organization chart (current and past) when discussing the changes with the head of the department during the C-Level interviews. Management may at that time be able to provide a more complete picture and reason for the changes. They may also provide an overview of mitigation measure put in place while there are open positions and/or individuals performing dual roles.

Generally speaking, all companies should have some type of risk regarding personnel in their risk repository, whether considered significant or not. The risk could be specific to the company and/or insurance industry overall. If they do not, examiners and analysts should likely follow up on why as it may indicate management is not aware of the current job market trends.

Management should also be able to demonstrate its awareness of the current job market and/or compensation trends given the importance of retaining experienced personnel; being unable to do so may indicate they are not appropriately budgeting for future costs or providing adequate training or taking into account work-life balance considerations.

Industry Developments
Significant changes in hiring, terminations, retirements and/or changes in compensation generally make the news for larger insurance companies. It would be beneficial to monitor the news for any specific changes to the company. It would also be good to monitor the overall job trends for the insurance industry. These changes should be considered when monitoring and/or examining companies in the future.

Some good monitoring sites are S&P Global and the Jacobson and Aon U.S. Insurance Labor Market Outlook Study. Individuals can set up email alerts on their websites for areas of interest specific to companies and/or the insurance industry as a whole. The Jacobson and Aon Outlook study is an online survey completed by management at their discretion, which includes key questions on job outlook specific to the insurance industry.

Company Website/Job Postings
Many larger companies have job listings right on their websites that includes how long positions are open. These open positions and length of time opened could provide some insights in questions to ask management about turnover, open positions, higher risk areas/departments, or what management is doing to fill these positions. One company had job postings for middle management that had been open for months, which led to higher risk of fraud as there was less segregation of duties.

Employee Surveys and/or On-Site Visits
The overall results of employee surveys could identify overall morale issues amongst employee. Low morale may be due to rate of change, planned restructuring, fear of changes as a result of COVID-19 or other. It may be good to review the surveys if examiners identify a potential morale risk.

In one past exam, almost the entire management team had changed due to retirements and change in the Chief Executive Officer. The CEO was making numerous changes. This made us wonder could they lose their personnel as a result of the all the changes going on. The surveys were anonymous and helped us to get a sense that employees accepted the changes as were well informed by management of not just the changes but also the reason for the changes. This resulted in employee buy in and excitement for the changes. While the company lost some personnel, it was not significant when compared to overall turnover rate for the industry.

Another method to identify personnel risks can be through general atmosphere and/or mood of employees as experienced first-hand when on site. Usually you can get a sense of company morale just from seeing the overall atmosphere of the company.

Additional Personnel Risks to Consider
Examiners should consider expanding their personnel risks outside the generic the Company is not implementing appropriate succession planning at the Executive Level.

The list is not all inclusive as it should be modified to suit each specific company.

- The Company's is unable to retain and hire qualified personnel or is unable to compete to retain and hire qualified personnel.

- The Company is experiencing difficulty filling specific vacancies especially in IT, Insurance Sales Agents, Market Research Analysts or others.
- Management is not managing the pace of change (such as implementation of new technologies or other strategic changes) to match their personnel's tolerance level.
- The Company is not appropriately budgeting for compensation and recruitment costs to retain and hire qualified personnel.
- Management has not implemented appropriate programs to mentor and train employees especially as hiring more personnel without and/or with less of an insurance background.
- Management is not knowledgeable about job trends and their competitors' recruitment or compensation practices resulting in loss of experienced personnel.
- The Company's business continuity plan needs to be updated based on negative issues experienced during the stay at home orders due to COVID-19.
- Personnel morale is low or there is increased risk of fraud due to layoffs, furloughs or salary cuts due to COVID-19.
- The Company has not appropriately improved its IT or other business operations due to change in its model from working in the office to have individuals work from home.
- The Company's operations are significantly impacted as unable to have employees work remotely.

For consideration, identified personnel risks may need to be viewed for what the overall impact could be for the company. For instance, lack of personnel, morale issues or other personnel risk could cause:

- The overall corporate governance assessment to be weaker.
- These could be identification for potential fraud factor that needs to be considered in the branded risk assessment and/or during the next examination.
- It could cause lack of segregation of duties or other internal control issues.
- It may help identify some key risk activities for examiners to focus on during the next examination or could increase the overall risk assessment for the company and/or specific branded risks.

Closing Remarks

This article only presents certain personnel risks being faced by the insurance industry and some best practices to identify and test the personnel risks identified. Examiners and analysts should be on the lookout for other personnel risks throughout their surveillance cycle and document any risk to be specific to the company being examined as it may increase risks for other areas.

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Market Briefing 3Q2020: A Second Half Story Begins

By Edward Toy
Risk & Regulatory Consulting, LLC

Introduction

Following on our last Market Briefing from earlier this year (March 11, 2020), to say that we have experienced a roller coaster ride in the last six months would be an obvious understatement. The impact of the pandemic on the US economy was severe and we should expect that repercussions will be felt for some time, with some sectoral changes perhaps being permanent. As will be discussed later in greater detail, capital markets were also heavily impacted. While many market indices have seen substantial recovery, those broader indicators that are commonly relied on do not tell the entire story. Looking only modestly below the surface, we can see continuing vulnerabilities and weakness in many sectors. As we seek to understand the impact on US insurer investments, it makes sense to remind ourselves of what US insurers are invested in as well as consider related investment practices.

	Total Industry		Life Industry		P&C Industry		Health Industry	
	2018	2019	2018	2019	2018	2019	2018	2019
SHORT TERM INVESTMENTS								
ST Investments & Cash Equivalents	208,319,709	236,037,299	92,814,903	104,589,155	88,258,938	102,296,104	27,245,868	29,152,040
LONG TERM INVESTMENTS								
Corporate Bonds	2,204,048,514	2,305,522,911	1,800,989,943	1,874,322,233	354,116,453	376,870,258	48,942,118	54,330,421
Bank Loans	51,815,167	57,790,884	38,473,016	43,244,285	11,684,628	12,956,342	1,657,523	1,590,257
Government Bonds (incl Municipals)	842,737,163	817,818,713	385,891,590	381,267,108	415,780,042	398,580,310	41,065,531	37,971,295
Agency CMBS	69,305,534	80,636,890	47,370,308	50,781,956	20,762,060	27,803,085	1,173,166	2,051,849
Agency RMBS	277,530,504	284,764,167	173,532,944	165,186,733	87,345,051	97,573,330	16,652,509	22,004,104
Agency ABS	24,089,162	25,515,657	16,466,692	16,255,622	7,243,241	8,824,528	379,229	435,506
Non-Agency CMBS	172,265,553	186,069,533	130,029,415	139,207,027	37,662,599	40,849,776	4,573,539	6,012,730
Non-Agency RMBS	95,017,627	93,327,934	74,999,177	73,623,388	18,842,266	18,123,344	1,176,184	1,581,202
Non-Agency ABS	337,151,976	378,418,539	265,851,059	294,879,375	61,315,354	72,154,262	9,985,563	11,384,901
Hybrids	15,945,091	16,692,161	12,569,742	13,020,155	3,069,363	3,328,473	305,986	343,533
SVO Funds	7,173,647	8,721,530	3,608,966	3,223,403	2,171,482	2,799,444	1,393,198	2,698,684
Subtotal Bonds	**4,097,079,936**	**4,255,278,920**	**2,949,782,852**	**3,055,011,284**	**1,019,992,538**	**1,059,863,153**	**127,304,546**	**140,404,482**
Preferred Stock	17,035,335	27,010,370	11,289,694	12,155,867	5,161,870	14,265,274	583,771	589,229
Common Stock	322,701,575	407,647,411	27,081,866	30,294,019	288,233,329	368,368,724	7,386,380	8,984,668
Funds as Common Stock	38,736,982	45,842,263	6,599,063	7,004,223	20,318,070	25,118,239	11,819,848	13,719,801
Subtotal Equity	**378,473,892**	**480,500,043**	**44,970,623**	**49,454,109**	**313,713,269**	**407,752,236**	**19,790,000**	**23,293,698**
Commercial Mortgage Loans	483,994,591	521,770,643	465,808,747	501,787,593	18,080,076	19,800,197	105,768	182,854
Mezzanine Loans	10,192,943	10,400,921	9,823,804	9,400,998	357,789	999,922	11,350	-
Residential Mortgage Loans and Other	46,800,248	54,688,575	45,265,160	53,431,936	1,507,346	1,256,639	27,742	-
Problem Mortgages	1,006,538	1,473,856	968,626	1,306,034	37,912	167,822	-	-
Non-Insurer Occupied Real Estate	19,288,873	21,827,428	14,625,630	17,141,221	4,414,655	4,520,113	248,588	166,094
Subtotal Real Estate Related	**561,283,193**	**610,161,423**	**536,491,967**	**583,067,782**	**24,397,779**	**26,744,692**	**393,448**	**348,948**
Non-Conforming LT Assets (BA)	158,431,638	171,787,460	101,586,260	110,805,288	50,765,372	54,259,003	6,080,006	6,723,169
Affiliated Investments (incl Occupied RE)	597,026,252	665,263,966	177,600,740	195,496,161	389,943,703	437,363,502	29,481,809	32,404,303
Grand Total - Long Term Investments	**5,792,294,911**	**6,182,991,811**	**3,810,432,443**	**3,993,834,624**	**1,798,812,661**	**1,985,982,586**	**183,049,808**	**203,174,601**

The profile of long term invested assets of US insurers does not change very much from one year to the next. Recognizing that US insurers largely still operate an investment model that leans more towards buy and hold than actively managed, the turnover ratio of Life insurers, where the bulk of the industry's invested assets reside, is about 10% per year. Changes in the investment program for an insurer in any one year will only shift the overall percentages modestly. However, incremental changes each year will accumulate into more substantive differences over time. We have definitely seen that over the last five to ten years, and more. Some the more substantive changes are the result of basic changes in what is available in the market as insurers have to invest within the larger context. Other changes become apparent as the industry gains increasing comfort in asset types. And, it is inevitable that US insurance companies, like investors everywhere, have had to look to different investments and investment strategies to bolster investment income as low interest rates have become the new normal. Reviewing the year-end 2019 data and comparing to year-end 2018 data, the invested assets of US insurers continued along the same general direction that they have been headed in for several years now. Now peaking just over $6 trillion, total industry assets continue to be weighted towards bonds. On the other hand, the shift to real estate related assets, primarily commercial mortgage loans took another step forward. Commercial mortgage loans totaled $521.8 billion, an increase of $37.8 billion. Most of the exposure and most of that year over year increase was among Life insurance companies. With a strong equity market in 2019, common stock exposure also increased by $84.9 billion, with most of that increase among P&C insurers. Less material but nonetheless worth serious consideration are increased exposures to investments reported on Schedule BA, primarily private equity funds. In the table above, more difficult to discern without substantial effort are those affiliated investments that are actually vehicles for investing in capital markets.

	Total Industry		Life Industry		P&C Industry		Health Industry	
	2018	2019	2018	2019	2018	2019	2018	2019
SHORT TERM INVESTMENTS								
ST Investments & Cash Equivalents	4.01	4.28	2.55	2.75	6.26	6.61	17.74	17.07
LONG TERM INVESTMENTS								
Corporate Bonds	42.42	41.78	49.58	49.35	25.13	24.34	31.87	31.81
Bank Loans	1.00	1.05	1.06	1.14	0.83	0.84	1.08	0.93
Government Bonds (incl Municipals)	16.22	14.82	10.62	10.04	29.51	25.74	26.74	22.24
Agency CMBS	1.33	1.46	1.30	1.34	1.47	1.80	0.76	1.20
Agency RMBS	5.34	5.16	4.78	4.35	6.20	6.30	10.84	12.89
Agency ABS	0.46	0.46	0.45	0.43	0.51	0.57	0.25	0.26
Non-Agency CMBS	3.32	3.37	3.58	3.66	2.67	2.64	2.98	3.52
Non-Agency RMBS	1.83	1.69	2.06	1.94	1.34	1.17	0.77	0.93
Non-Agency ABS	6.49	6.86	7.32	7.76	4.35	4.66	6.50	6.67
Hybrids	0.31	0.30	0.35	0.34	0.22	0.21	0.20	0.20
SVO Funds	0.14	0.16	0.10	0.08	0.15	0.18	0.91	1.58
Subtotal Bonds	78.86	77.12	81.20	80.43	72.40	68.44	82.90	82.22
Preferred Stock	0.33	0.49	0.31	0.32	0.37	0.92	0.38	0.35
Common Stock	6.21	7.39	0.75	0.80	20.46	23.79	4.81	5.26
Funds as Common Stock	0.75	0.83	0.18	0.18	1.44	1.62	7.70	8.03
Subtotal Equity	7.28	8.71	1.24	1.30	22.27	26.33	12.89	13.64
Commercial Mortgage Loans	9.32	9.46	12.82	13.21	1.28	1.28	0.07	0.11
Mezzanine Loans	0.20	0.19	0.27	0.25	0.03	0.06	0.01	-
Residential Mortgage Loans and Other	0.90	0.99	1.25	1.41	0.11	0.08	0.02	-
Problem Mortgages	0.02	0.03	0.03	0.03	0.00	0.01	-	-
Non-Insurer Occupied Real Estate	0.37	0.40	0.40	0.45	0.31	0.29	0.16	0.10
Subtotal Real Estate Related	10.80	11.06	14.77	15.35	1.73	1.73	0.26	0.20
Non-Conforming LT Assets (BA)	3.05	3.11	2.80	2.92	3.60	3.50	3.96	3.94

The table above takes a different perspective on the earlier data in the first table. In this case, the focus is on each asset type as a percent of the total of cash and invested assets. While it is a different view, the conclusions are largely the same. Bonds continue to remain the mainstay of US insurers, though it continued to slip slightly in 2019 as a percent of the total, from 78.86% to 77.12%. Within total bonds, corporate bonds are the majority, but also represent a smaller percentage. The same is true of government bonds. The beneficiary of these lower percentages are continued increases in structured securities. In a more detailed view, residential mortgage-backed securities (RMBS) continued the decline we have seen for several years, both for agency-backed and non-agency securities. The main area of increase is in non-agency asset-backed securities (ABS). Outside of bonds, the percentages reflect a modest increase in commercial mortgage loans, from 9.32% to 9.46%. There was also a small increase in the percent of investments reported on Schedule BA. This is not surprising given that the bulk of those assets are in private equity funds which would have similarly benefited from the strong equity market in 2019 which were up around 30%.

As previously noted, US insurers tend to be more buy and hold investors. This is especially true of Life insurers that include asset-liability matching as an important influence on their investment strategy over time. Notwithstanding that, US insurers have also grown increasingly market conscious. Anecdotally, US insurers have been known to increase their level of trading activity during times of market volatility, taking advantage of drops in asset prices and providing pricing support to those assets where there is perceived value. This was clearly the case with a number of larger insurers when analyzing second quarter transactions data. While the data was only reviewed for a small sample of insurers, what was apparent in several was an increase in asset turnover in the second quarter, reflecting as much as a 100% increase over the same period in 2019. The data did not suggest what would be considered "panic selling", as realized capital losses were minimal. Instead, what appeared to be the case was selling of lower yielding assets, as in government bonds, and reinvestment in non-government bonds that were available at lower prices.

The breakdown of the industry's invested assets is as important as it has ever been as we consider the impact of the pandemic in 2020 and beyond. Subject to the likelihood of revisions, US Gross Domestic Product (GDP) is estimated to have dropped by an annualized rate of 32.9% in the second quarter. That has a direct impact on corporate earnings, government tax revenues on all levels, and default rates for virtually every asset type. However, the impact will vary across different parts of the economy, and the pace of recovery will also vary.

Life	2015Y	2016Y	2017Y	2018Y	2019Y
Bond Portfolio Maturity Score	13.80	13.84	14.11	13.95	13.91
1 or less	8.2%	8.0%	6.6%	6.9%	7.5%
1 to 5	24.6%	24.7%	24.9%	25.0%	25.0%
5 to 10	30.5%	30.1%	29.9%	30.3%	29.7%
10 to 20	15.8%	16.4%	17.8%	17.4%	17.3%
greater than 20	21.0%	20.8%	20.8%	20.4%	20.5%
Greater than 10 year	36.7%	37.2%	38.6%	37.8%	37.8%

P&C	2015Y	2016Y	2017Y	2018Y	2019Y
Bond Portfolio Maturity Score	8.65	8.66	8.52	8.37	8.07
1 or less	16.3%	15.5%	15.4%	13.9%	15.6%
1 to 5	35.9%	36.3%	37.2%	39.6%	40.7%
5 to 10	33.7%	34.5%	34.3%	34.3%	32.4%
10 to 20	9.0%	8.7%	8.6%	8.2%	7.5%
greater than 20	5.1%	5.0%	4.5%	3.9%	3.8%
Greater than 10 year	14.1%	13.7%	13.1%	12.2%	11.3%

Health	2015Y	2016Y	2017Y	2018Y	2019Y
Bond Portfolio Maturity Score	7.64	7.30	7.79	8.07	7.48
1 or less	24.7%	25.1%	19.0%	16.6%	17.7%
1 to 5	39.5%	39.3%	41.7%	43.0%	44.9%
5 to 10	24.0%	25.7%	28.8%	28.9%	28.4%
10 to 20	5.3%	4.7%	5.2%	6.0%	4.9%
greater than 20	6.5%	5.3%	5.3%	5.6%	4.1%
Greater than 10 year	11.8%	9.9%	10.6%	11.5%	9.0%

As investors in general have sought to increase portfolio yields in the low interest rate environment, one frequently cited approach has been to extend duration, to go farther out on the yield curve. Shortly after the 2008 financial crisis, it was noted that US insurers significantly decreased the duration of these investments, reflecting uncertainty about the direction of US monetary policy. This tendency was reversed and in the data in the above table, we can see that the maturity profile has been relatively stable for all three insurer groups over the last five years. While maturity is not a perfect translation of duration risk, it is the data that is readily available from insurers' investment schedules and should nonetheless offer a reasonable directional view of any significant changes over time.

Of greatest interest in the data is the percentage of bonds that have maturities of ten years or greater. Assuming a reasonable translation into duration of those same investments, those bonds would see the most significant degree of market value volatility with changes in interest rates. For Life insurers, the percentage has been relatively unchanged over the five year period. For Property & Casualty and Health insurers, there has been a modest decrease in that percentage.

Life	2015Y	2016Y	2017Y	2018Y	2019Y
Bond Portfolio Credit Sore	1.46	1.47	1.47	1.48	1.47
NAIC 1	62.4%	62.4%	62.0%	60.4%	60.6%
NAIC 2	31.7%	31.5%	32.3%	34.2%	34.2%
NAIC 3	3.9%	3.9%	3.6%	3.3%	3.2%
NAIC 4	1.5%	1.6%	1.6%	1.5%	1.4%
NAIC 5	0.4%	0.5%	0.5%	0.5%	0.5%
NAIC 6	0.1%	0.1%	0.1%	0.1%	0.1%
Below Investment Grade	5.9%	6.1%	5.7%	5.3%	5.2%

P&C	2015Y	2016Y	2017Y	2018Y	2019Y
Bond Portfolio Credit Sore	1.27	1.28	1.26	1.27	1.28
NAIC 1	81.6%	81.0%	80.9%	79.9%	79.8%
NAIC 2	13.9%	14.2%	14.7%	16.2%	15.8%
NAIC 3	2.1%	2.3%	2.3%	2.0%	2.1%
NAIC 4	1.3%	1.6%	1.7%	1.6%	1.7%
NAIC 5	0.9%	0.9%	0.3%	0.3%	0.4%
NAIC 6	0.2%	0.2%	0.1%	0.1%	0.2%
Below Investment Grade	4.5%	4.9%	4.4%	3.9%	4.4%

Health	2015Y	2016Y	2017Y	2018Y	2019Y
Bond Portfolio Credit Sore	1.25	1.25	1.28	1.29	1.29
NAIC 1	81.3%	81.4%	79.6%	78.4%	77.7%
NAIC 2	14.4%	14.0%	15.6%	16.5%	17.5%
NAIC 3	2.7%	2.9%	2.8%	2.9%	2.8%
NAIC 4	1.4%	1.6%	1.9%	1.9%	1.7%
NAIC 5	0.2%	0.2%	0.2%	0.2%	0.2%
NAIC 6	0.1%	0.0%	0.0%	0.0%	0.1%
Below Investment Grade	4.3%	4.6%	4.9%	5.1%	4.8%

Historically, credit risk has been considered one the most significant risks with US insurers' investment portfolios. While this may still be the case, from the data in the table above, it also appears to be a risk that is being reasonably well managed. The percentage of bond portfolios in below investment grade bonds has not changed much in the last five years for any of the US insurer types. Life insurers have generally decreased their exposure to below investment grade bonds since the 2008 financial crisis. Property & Casualty and Health insurers did materially increase their below investment grade exposure, to be closer to the Life insurer averages, several years ago. However, those increases have moderated since 2015. On the other hand, for all three insurer types, there have been increases in bonds with an NAIC 2 Designation, which would reflect a BBB rating agency rating. These would be most at risk of downgrade to below investment grade in an environment as we are experiencing, especially those on the cusp with a BBB-minus rating. The increase in BBB-rated exposures through 2019 also is indicative of the general trend in the market place as BBB-quality bonds are accounting for roughly half of the investment grade market, a significant increase over earlier years.

Derivatives - Notional Value	2015Y	2016Y	2017Y	2018Y	2019Y
Life	1,814,408,549	2,013,269,077	1,943,850,756	2,071,704,690	2,308,181,342
P&C	42,364,010	40,580,669	42,615,823	52,885,563	53,338,856
Health	150,041	908	538	400,158	400,631
Total	1,856,922,600	2,053,850,654	1,986,467,118	2,124,990,412	2,361,920,829

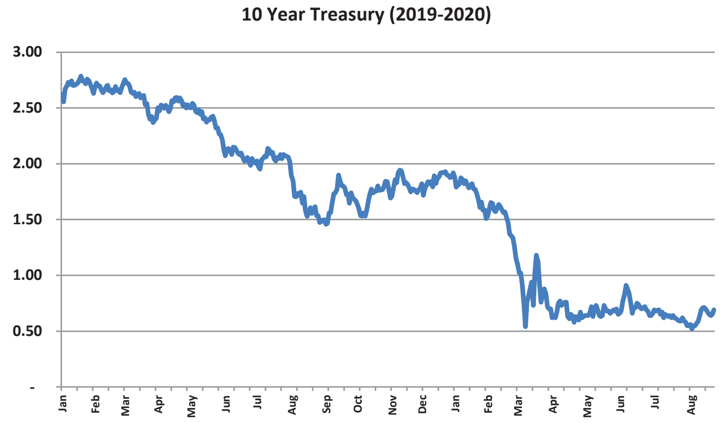
Securities Lending	2015Y	2016Y	2017Y	2018Y	2019Y
Life	48,705,377	46,851,017	48,207,447	41,644,999	43,439,843
P&C	2,707,340	3,051,177	4,942,502	5,941,209	5,908,155
Health	1,306,790	1,203,708	723,549	977,540	951,999
Total	52,719,507	51,105,902	53,873,499	48,563,749	50,299,997

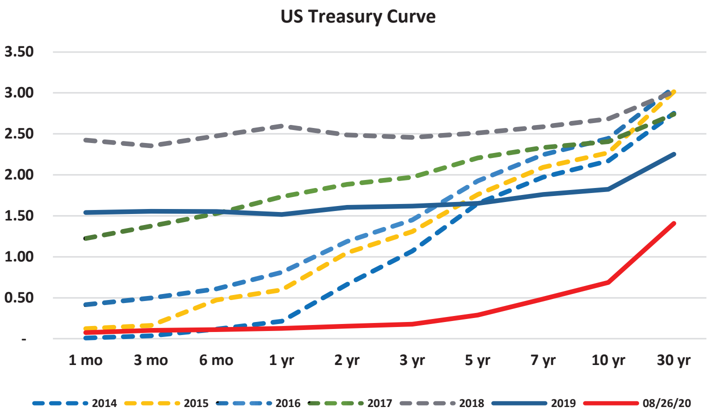
Repurchase Agreements	2015Y	2016Y	2017Y	2018Y	2019Y
Life	24,062,818	23,901,206	23,176,076	26,175,493	23,752,512
P&C	1,881,762	1,726,698	1,751,418	1,643,093	2,170,432
Health	19,819	19,483	5,665	68,379	92,580
Total	25,964,398	25,647,387	24,933,159	27,886,965	26,015,524

In addition to what US insurers report as invested assets, it is also important to consider other investment practices. The most significant of these are derivatives transactions and securities lending, along with repurchase agreements. For all three of these, US insurers account for a relatively small percentage of the overall market activity.

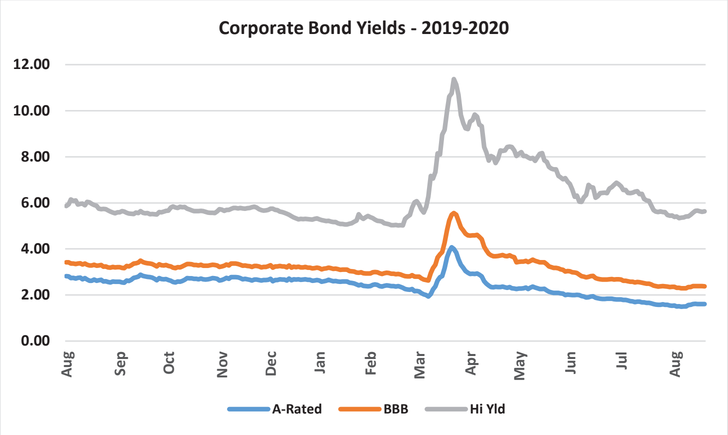
The notional value of derivatives is not a good indicator of risk, but is a reasonable reflection of derivatives activity. That continues to show consistent growth over the five year time period. Also, it is worth remembering that derivatives activity among US insurers is almost entirely dedicated to hedging, though most is not deemed to be hedge effective. From the standpoint of notional value, Life insurers represent the main users of derivatives, and even among Life insurance companies is concentrated in a relatively small number of the largest companies. Activity in both securities lending and repurchase agreements has been relatively unchanged in the last five years.

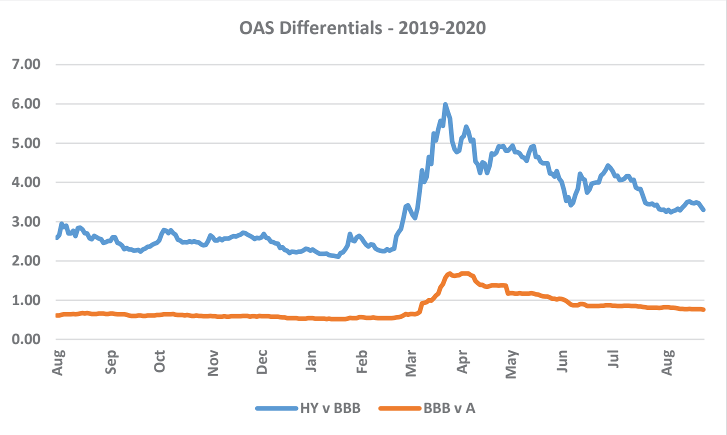
Markets


10 Year Treasury (2019-2020)

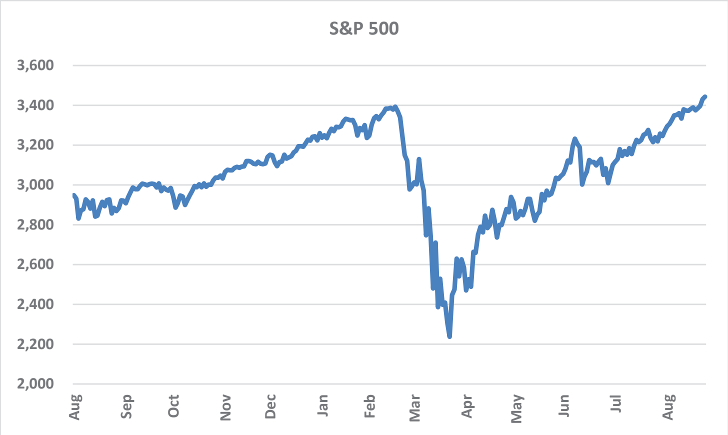

US Treasury Curve

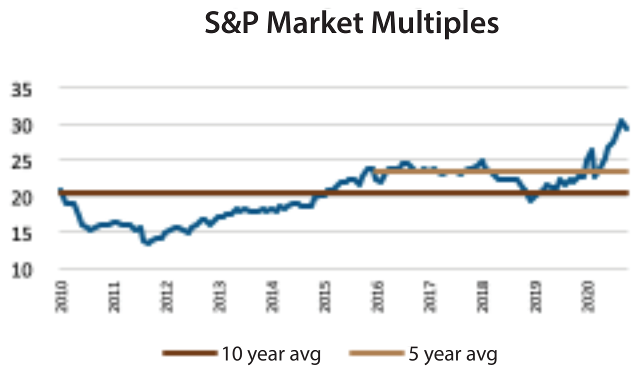
With nearly 90% of the US insurance industry’s invested assets being in some form of fixed income investment, there is no doubt that the level of interest rates is a critical aspect of the market environment. The Federal Reserve Board of Governors (the Fed) had been gradually moderating its accommodative monetary policy though 2018, resulting in interest rates moving slightly up. With the onset of the pandemic and reflecting concerns about the impact on the economy, the Fed moved aggressively to lower interest rates and push liquidity into the market place. The Fed lowered its targets for short term interest rates and also pledged as much as $10 trillion to a buying program for longer dated bonds. This included a much broader list of asset types than even the 2008 financial crisis. The result was a decline in interest rates across the entire yield curve by 100 basis points or more, and a 10-year Treasury yield that hit its lowest level in modern memory, and as of the end of August was only approximately 65 basis points. The US Treasury yield curve had already been flattening significantly from 2016 as the market grew increasingly concerned over the longer term prospects for the economy. Notwithstanding a modest steepness in the yield curve out at the longest maturities, the flat yield curve with a 10-year Treasury yield, often considered a sweet spot of the market, at well less than 1.00% represents a major challenge for insurers that have historically sought to match longer duration liabilities with longer duration assets and gain a yield advantage by doing that. With the current market, that advantage is virtually non-existent, while still resulting in market value volatility when interest rates begin to rise.





US insurers commit a relatively small percent of their invested assets to government bonds. Corporate bond yields, and their option adjusted spreads (OAS), are more reflective of actual investment yields for the bulk of the portfolios. Both of those spiked in March with the onset of the pandemic. Since then, there has been a substantial recovery. However, that recovery has not been entirely uniform. The yield and OAS on higher quality bonds have not only recovered, but as a general statement are both lower than pre-pandemic levels. The differential (the graph above on the right) between those higher quality investments (in the graphs above represented by A-rated bonds) and middle quality investments (BBB-rated), and even more so between BBB-rated and High Yield bonds, widened with the pandemic and have not fully recovered.

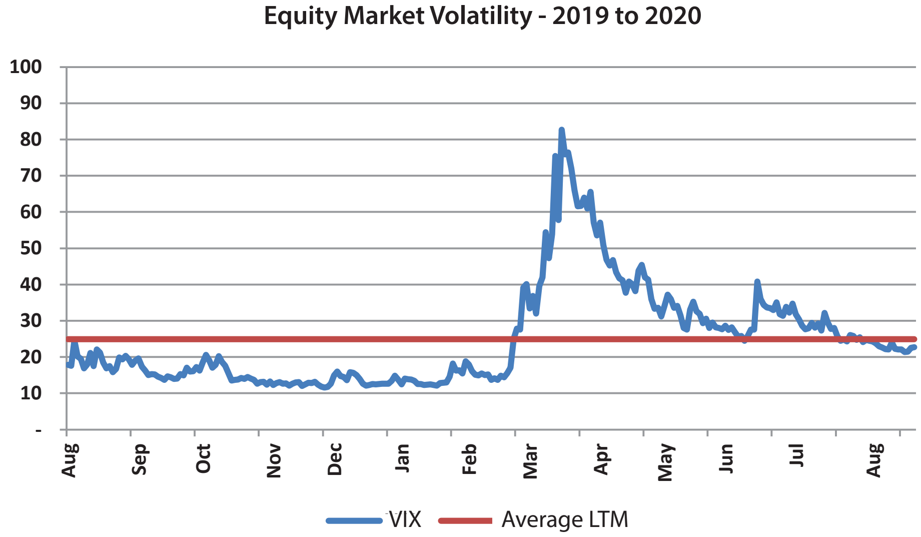


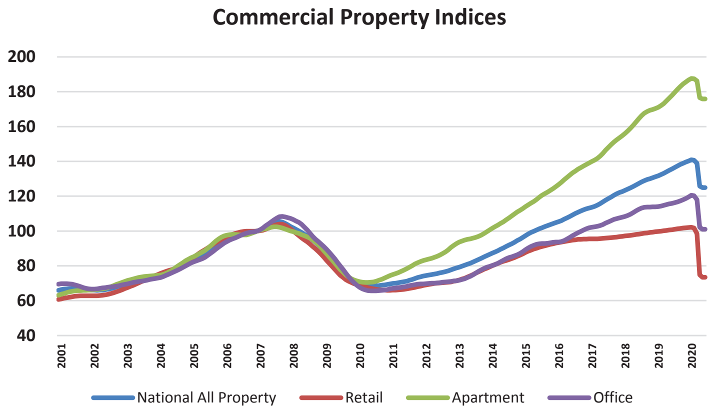


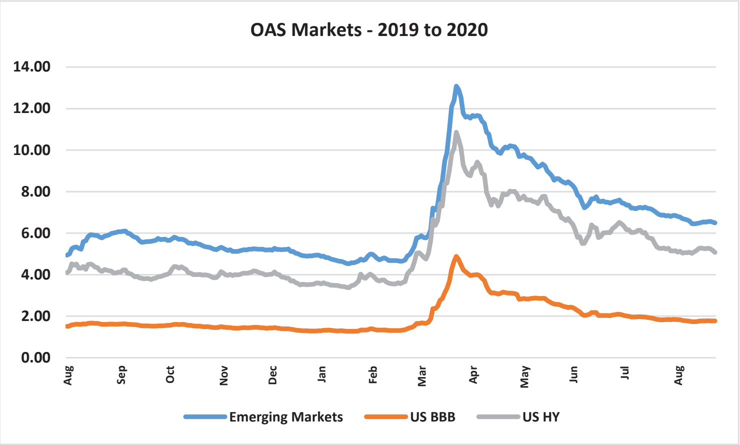
Equity markets with the pandemic fell 30% from the end of February to the end of March, a period of roughly five weeks. In comparison, with the 2008 financial crisis, equity markets fell 45%, but that was spaced out over a period of nearly eighteen months. The pace of the decline in the early days of the pandemic has been almost equally matched in the recovery, at least as it is reflected in the S&P 500 index. This, however, is not a complete picture as the direction of the S&P 500 index, along with other equity indices, has been heavily driven by companies with larger equity capitalizations. This was especially the case with equity of technology related companies that up until the last few days were dramatically outperforming other sectors. Focusing on other sectors, the recoveries have been much more lackluster. Those sectors most heavily impacted by the pandemic are those related to travel and leisure. Equities of financial institutions, including banks, insurance companies and broker-dealers, are still down nearly 20% since the beginning of 2020.

The strength of the recovery in equities may also somewhat suspect. Judging by the graph above on the right, the recovery in equities is built on higher and higher multiples as earnings have been driven lower by the considerable decline in economic activity. Current estimates of market multiples are in the range of 30 times, well in excess of either the five-year or ten-year average.

Since US insurers are not total return focused and geared more towards a buy and hold investment strategy, equity market volatility, as represented on the left, or bond market volatility are not a major area of concern for most of their investment practices. Where volatility may still be an issue is in derivatives valuation since assumptions of volatility are a significant input in that valuation. This may also influence considerations of hedge effectiveness. Volatility spiked in March and has largely come back but is still modestly higher than pre-pandemic.







The growth in investments in commercial real estate related assets over the last five to ten years means that there is increased exposure to volatility in real estate valuations. While most of the investments are in commercial mortgage loans, there is also exposure through commercial mortgage-backed securities (CMBS), real estate investment trusts (REITs), debt and equities of property managers and, indirectly, through banks that may have substantial exposures to all of those asset types. Going into 2020, there were already increasing concerns about inflated property values and loosening of underwriting standards in mortgage lending. This was especially the case for the retail sector which has been struggling to reinvent itself in recent years. The pandemic further exposed those vulnerabilities. Data on how this has impacted values is thus far relatively incomplete, but what is available is represented in the graph above on the left. Retail along with Lodging, which is not depicted, have suffered 20% to 30% drops. Apartment and Office have not seen as a dramatic a change, but longer term prospects are still uncertain. With still a substantial degree of uncertainty, the American Council of Life Insurers (ACLI) is working with the Life Risk-Based Capital Working Group on guidance that would not take full account of the downturn in 2020 as it may impact loan-to-value and debt service coverage ratios. The rationale is that 2020 is a unique situation that was at least partially driven by government imposed shutdowns.

While commercial mortgage lending should be considered a core asset for the US insurance industry, there are other asset classes where many insurance companies have invested in on the margin. Sometimes referred to as cusp markets, most investors participate in these asset types only as an enhancement to portfolio yield, but are readily exited when markets become less reliable. One of those is emerging markets debt. In the above right graph, option adjusted spreads for emerging markets debt is compared with US corporate issues for BBB-rated and high yield. The option adjusted spread on emerging markets debt versus US high yield has ranged from a high of 450 basis points to a negative 20 basis points. The more recent peak in March was 300 basis points, with the current differential at 125 basis points.

The (Totally Not) Final Word

It is likely at least many months before the extent of the impact of the pandemic on investment markets can be fully grasped. One area that has not been mentioned earlier in this Market Briefing is any increase in defaults among bonds, loans and mortgages. While defaults across different asset types have increased, these increases have thus far been significantly below what some analysts had feared. Recent analysis by S&P Global has shown that defaults on bank loans have increased to just over 4.0%, with continuing expectations that could reach 7.5% by year-end. Estimates of defaults on commercial mortgage loans have increased to 10.3% among those supporting CMBS, with lower percentages for the broader market. Defaults on residential mortgage loans are also around 7.8%. To some degree, defaults may have been delayed by various forbearance programs and initiatives offered by Federal, state and local governments. As these programs begin expire, will the economy have recovered enough to avoid a spike in defaults? If the overall economy takes longer to fully recover, will the high expectations reflected in equity valuations reverse? If both of these more dire trends take hold, will credit spreads spike again? More to come.

SOFE Editor's Note: This Market Briefing was originally distributed by Risk & Regulatory Consulting, LLC on September 14, 2020. Reprinted with permission.

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Boardroom Advice for Handling Disruptive Risk

By Paul L. Walker, CPA, Ph.D. and Thomas L. Barton, CPA, Ph.D.

When risks seem to be unmanageable, it may be time to move away from traditional models of risk management.

In the late 1990s, online bookseller Amazon had a very uncertain future. Now its market capitalization is almost $900 billion. And it has revolutionized retailing.

Around the same time, it would have been inconceivable that Apple, a struggling technology company, would almost singlehandedly turn cellphones into miniature computers, capable of delivering high-definition audio and video as well as a multitude of advanced features that people take for granted today. Apple's market capitalization is now almost $1.2 trillion.

Microsoft, Google, and Facebook round out the top five technology companies. And with the exception of Microsoft, these companies have revolutionized their sectors in just a few years. Consumers of the goods and services these companies provide would not think of the whole technology revolution as "disruptive." But competing companies certainly would.

For this reason, it is perhaps not surprising that, historically, relatively little guidance has been available about what organizations can do to anticipate and control disruptive risk, the sort of business development that can put a company out of business, often because of some unseen, outside competitor. Recently, strong board involvement has been emphasized as a key part of efforts to manage disruptive risk.

Until recently, there has not been much discussion of disruptive risks as a separate category of risk. Traditional enterprise risk management (ERM) models did not emphasize disruptive risks and their capabilities. Netscape browser, anyone? Or how about the Altavista search engine?

The real difficulty lies in the truism that disruption emanates quickly and from outside the organization. What chance does an organization have to manage such a potentially ruinous risk? It's no surprise that the risk seems almost unmanageable.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO), the National Association of Corporate Directors (NACD), and other bodies that provide guidance on risk management have focused on board involvement in managing disruptive risk. This approach has much promise since disruptive risk must be addressed at the highest levels of the organization. The approach is clearly sound, but implementation is another matter.

Many board members do not realize how critical the board risk oversight role is in creating, protecting, and enhancing shareholder value. "The pressure on boards of directors to oversee and manage risk is greater than ever before," according to a Diligent Insights blog post, "Board Oversight of Risk Management." One New York Stock Exchange (NYSE) board member once asked about a company that went bankrupt during his oversight, "Could ERM have helped saved the company? Could better ERM or board involvement have helped us see the disruptive risks sooner, assess it better, manage the risk better?"

Recent headlines tend to support these types of questions and the potential game-changing role of boards in this area. Some of the headlines are startling. For example, the former CEO of Cisco recently and famously stated, "40% of companies will be dead in 10 years." Other studies seem to echo the concern with some studies showing the life span of a Fortune 500 company dropping dramatically and some forecasting that half of the S&P 500 will be replaced in 10 years. Additional studies show dramatic shifts in the top 10 companies in the last 25 years, and some studies note that the topple rate of companies (how quickly they fall) is growing dramatically.

There can also be regulatory pressure. Current NYSE requirements state that the audit committee is supposed to discuss policies with respect to risk assessment and risk management and that the CEO and senior management have responsibility to assess and manage risk. The SEC's 33-9089 rule requires that companies disclose the board's role in risk oversight. Interestingly, almost every major economy has moved toward some stronger form of ERM and board risk oversight. A 2019 survey shows that ERM is more understood and valued than it was 10 years ago. Yet, The State of Risk Oversight, an annual survey by the AICPA and North Carolina State University, also shows that robust risk management remains a struggle for many organizations.

In response to this pressure, information and suggestions on how to improve board risk oversight are flowing from organizations and their research. These groups include the NACD and consultancy Protiviti, which publishes an annual survey in collaboration with N.C. State's Enterprise Risk Management Initiative. Below are some of the entities' suggestions, along with how ERM leaders and boards can respond and get more involved.

Question legacy business models

"Allegiance to legacy business models with reluctance to question their future viability" is a red flag, according to board guidance (Adaptive Governance: Board Oversight of Disruptive Risks, NACD, 2018).

ERM reaction: Include business model risk analysis in your risk assessment.

Board member reaction: Don't accept a risk map with a list of top risks. Ask if tools have been applied to examine the risks around the business model — in essence, the heart and soul of the business. Without a grasp of this, you are overseeing the wrong risk. Peter Drucker, a management consultant, educator, and author, wrote in "Theory of the Business" in the Harvard Business Review in 1994 that every three years we should challenge every product, service, policy, etc. — basically, every assumption about the business.

Assess emerging risks
"The board should carry out a robust assessment of the company's emerging and principal risks. The board should confirm in the annual report that it has completed this assessment, including a description of its principal risks, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated. … Principal risks should include, but are not necessarily limited to, those that could result in events or circumstances that might threaten the company's business model, future performance, solvency or liquidity and reputation. In deciding which risks are principal risks, companies should consider the potential impact and probability of the related events or circumstances, and the timescale over which they may occur" (UK Corporate Governance Code 2018).

ERM reaction: First, strengthen your emerging risks process. Second, include business model risk analysis in the process. This reaction captures the growing pressure on boards over emerging risks and business models. Recent work at the Center for Excellence in ERM at St. John's University's Tobin College of Business reveals that U.S. high-performing companies (as compared to those that are not high performers) are more likely to have an emerging risk process.

Board member reaction: There is no reason not to insist that companies push the dial higher than just doing risk identification, risk assessments, and risk ranking. Insist on an analysis of how the emerging and disruptive risks impact the business model. The future of the business could be at stake.

Watch for external risks
"Boards have concerns about less controllable, exogenous risks" (2019 Governance Outlook: Projections of Merging Board Matters, NACD). As an example, Pearson, the British publishing company, discloses in its annual report that it compares strategy to external risk data.

ERM reaction: Convince the board how you've done this. Use black swan or disruptive workshops to attempt to pull out these risks.

Board member reaction: One Fortune 100 company board insists the ERM leader show what external data has been used during the risk assessments. These cannot just be focused on internal surveys and interviews. You must get an external view and external data. Drucker was famous for warning us to study non-customers instead of just our current customers. Other major organizations conduct black swan or strategic disruption workshops and report those results to the board.

Identify trigger and interconnected risks
Organizations that focus only on risk maps and registers can miss trigger risks or interconnected risks. The 2017 COSO ERM Framework discusses the importance of seeing risks in a portfolio, but it is also important to know which risks occur first and either trigger other risks or create an excessive risk tipping point.

ERM reaction: Identify which risks could be the tipping point or the trigger. Managing/monitoring the non-trigger risk could be futile and result in your getting key risk information too late. Key risk indicators and risk mind maps can be helpful in mapping the path of risks and which risks might be triggers. Research from the Center for Excellence in ERM at St. John's University shows that monitoring of trends related to disruptive risks is the most frequently listed action/response by ERM leaders.

Board member reaction: Insist on an identification of trigger risks. These risks may be smaller and not on the radar screen because of their size. However, they can be the first sign that not all is well. At a minimum, ask what the risk drivers are.

Assess vulnerability to disruptive risks
A recent Gartner survey showed the top-rated risk was the pace of change and a related concern over being vulnerable to disruption. Similarly, at a recent ERM Summit, over 85% of ERM leaders agreed that digital disruption would have a significant impact on their organization, and 55% agreed that it was one of their top risks.

ERM reaction: Just do it. Get board members to schedule time to focus on and discuss disruptive risks arising from a variety of sources. Use data, trends, strategic risk analysis, innovations, or any tool that might help identify disruptive risks.

Board member reaction: Attempt to identify the most disruptive risks. Schemas showing future business growth, current capabilities, and potential "blue oceans" can help identify these. Some are proposing companies stress-test non-financial risks. We've seen one major company build risk shock calculators to determine just how much impact a major risk can cause. It helped them make better decisions.

Upskill to navigate disruptive risks

"Boards should invest in the skills — within the organization and on the board itself — needed to navigate disruptive risks" (Adaptive Governance: Board Oversight of Disruptive Risks, NACD, 2018).

> **ERM reaction**: Lead or train your board on how to identify disruptive risks and link them to the business model.
>
> **Board member reaction**: Board members should consider training on disruption, strategic risk, and its many dimensions (which COSO highlights), and the potential toolset that can be used to uncover such risks.

Maintain adaptive governance and foster challenges

"In the Commission's view, this will require boards to build ... adaptive governance, which we define as ... [a]ctive involvement by directors in setting and maintaining a boardroom culture that is centered on open discussion, constructive challenge ..." (Adaptive Governance: Board Oversight of Disruptive Risks, NACD, 2018).

> **ERM reaction**: Practice a challenge culture or contrarian view when risks are presented. Encourage boards to do the same. The goal is for the greater good of the organization.
>
> **Board member reaction**: At board meetings, observe how questions are asked, watch for group thinking, watch for thorough and challenging discussion of risks and business models, and insist on adequate time to review major risks and strategy. Ultimately, don't join a board unless it has this type of culture.

SOFE Editor's Note: This article was originally published by the AICPA Journal of Accountancy in the February 2020 edition. For the original version of this article, please visit https://www.journalofaccountancy.com/issues/2020/feb/handle-disruptive-risk.html. Reprinted with Permission.

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***Thomas L. Barton*, CPA, Ph.D.** is the Kip Professor of Accounting at the University of North Florida. He passed away in December.

NAIC Summer 2020 National Meeting Notes

By Lauren Williams Darr, CPA, Scott Haynes, CPA, CPCU, AIAF, and Joanne Smith, CFE, MCM, Johnson Lambert LLP

The NAIC Summer 2020 National Meeting, which occurred during July 27 through August 14, was the NAIC's first comprehensive virtual meeting. The NAIC utilized a video conferencing platform for multimedia presentations, video broadcast options for key speakers, and multiple join options for interested parties.

Statutory Accounting Updates

Ref #	SSAP No	Title	Revision Description	Effective
INT 20-08T	5R, 24, 53, 54R, 65, 66	COVID-19 Premium Refunds, Limited-Time Exception, Rate Reductions and Policyholder Dividends	Interpretation provides accounting guidance for COVID-19 related: • Refunds not required under policy terms shall be accounted for as a return of premium, or for P&C insurers that filed policy endorsements or manual rate filings prior to 06.15.20 and disclosed the intent to report the reduction as an expense, a limited-time exception permits expense reporting • Refunds required under policy terms – no changes • Rate reductions on inforce business shall be recognized immediately as a premium adjustment and rate reductions on renewal business are recognized in the premium rate charged at renewal • Policyholder dividends – no changes To allow aggregation of COVID-19 related disclosures for premium refunds, rate reductions and dividends, they should be reported as unusual or infrequent items in annual statement Note 21A. This temporary interpretation will sunset on 01.01.21.	07.30.20
INT 20-09	86	Basis Swaps as a Result of the LIBOR Transition	Basis swaps issued by Central Clearing Parties in response to reference rate reform should be reported at fair value as "Hedging Other" unless the instrument meets the requirements of SSAP No 86 of a highly effective hedge.	07.30.20
2020-01	26R, 30R	Update / Remove References to SVO Listings	Eliminates references to the "NAIC Bond Fund List". Funds previously included on that list are eligible for consideration in the "NAIC Fixed Income-Like SEC Registered Funds List."	07.30.20
2020-04	51R, 52, 54R	Commissioner Discretion in the *Valuation Manual*	A reporting entity must report a change in valuation basis if it voluntarily decides to select an allowable reserving methodology over another that requires commissioner approval.	07.30.20
2020-16EP	2R	Editorial and Maintenance Update	The update points to the Annual Statement Instructions for reporting cash pools.	07.30.20

Ref #	SSAP No	Title	Revision Description	Effective
2019-04	32R, IP 164	SSAP No. 32 – Investment Classification Project	The substantive updates: • Revise the definitions of redeemable and perpetual preferred stock • Delete the definitions of mandatory sinking fund preferred stock, payment-in-kind (PIK) preferred stock and step-up preferred stock • Add a definition for mandatory convertible preferred stock • Removes references to the "cost" measurement method • Adds guidance on mandatorily convertible redeemable preferred stock • Clarifies the reporting of PIK dividends and interest • Clarifies elements of the OTTI assessment for redeemable preferred stock Clarifies the interaction between SSAP No. 32 and SSAP No's 48 and 97	01.01.21
2019-38	86	Financing Derivatives	Defines derivative premium and requires derivatives be reported gross and exclude the impact of financing premiums. Related premiums payable and receivable must be reported separately.	01.01.21
2020-02	26R	Accounting for Bond Tender Offers	Clarifies the accounting for the early liquidation of a bond through a tender offer is the same as that of a called bond.	01.01.21
2020-05	106	Repeal of Affordable Care Act Section 9010 Assessment	Supercedes SSAP No 106 – *Affordable Care Act Section 9010 Assessment* and nullifies INT 18-02: *ACA Section 9010 Assessment Moratoriums*.	01.01.21
2020-03	68	Enhanced Goodwill Disclosures	Requires the following additional goodwill disclosures: • The original amount of goodwill • Each subsidiary, controlled, or affiliated entity book value • Total admitted goodwill as of the reporting date The subcomponents and calculation of adjusted surplus and total admitted goodwill as a percentage of adjusted surplus.	12.31.21

Interpretations With Effective Date Extensions

The SAPWG extended the effective dates of interpretations (INTs) 20-02T, 20-04 T and 20-05T through third quarter financial reporting. The INTs are set to expire December 30, 2020 (prior to 2020 annual reporting).

Reinsurance (E) Task Force

The Reinsurance Task Force presented a status report on the implementation of the 2019 Revisions to Credit for Reinsurance Model Law #785 and Model Regulation #786 which are pending adoption in many states. These models are scheduled to become accreditation standards by 2022, and nationwide adoption is crucial to the United States participation in the International Covered Agreement. As of July 7, 2020, 11 jurisdictions have adopted #785 and 17 jurisdictions are under legislative consideration. The Commonwealth of Virginia is the sole adopter of #786. Several meeting participants expressed concerns over the tight timelines to present the revised models given the impact of COVID-19 on the timing of legislative sessions.

Special Session on Race and Insurance

The NAIC Center for Insurance Policy and Research (CIPR) hosted three special sessions that included panels of experts who provided unique and educated insights to the NAIC on COVID-19: Lessons Learned, Hurricanes & Resiliency, and Race & Insurance. With an eye toward current events, a summary of the Race & Insurance session seemed particularly important.

The first group of panelists discussed how racism is perpetuated in the insurance industry and how minorities lack trust in the industry due to historical discriminatory practices. The panelists offered several solutions for the path forward, including:

- Recruiting more black insurance agents and financial advisors,
- Addressing financial literacy challenges in minority communities, and
- Promoting leadership development programs for black high performers so there are more black voices in insurance company leadership.

A second panel focused on insurance industry practices that inhibit diversity and inclusion, such as:

- Using big data gathered from social networks,
- Using credit scoring for tiered pricing as a proxy for racial bias, and
- Disparities in healthcare due to the lack of affordable health insurance that excludes essential benefits.

Proposed solutions include:

- Detecting discriminatory practices by collecting market conduct regulation data in the same robust manner as that used for financial regulation,
- Improving consumer education on insurance policies and coverage, and
- Ensuring equity in healthcare coverages by preventing unfair differences in healthcare coverage.

The final panel consisted of seven Insurance Department Commissioners and Directors that shared their personal experiences with racism and diversity and initiatives in their jurisdictions and spheres of influence to promote inclusion and diversity.

To effect change in the industry, the NAIC created a Special Committee on Race and Insurance composed of Insurance Commissioners and Directors from 51 jurisdictions. The Special Committee's first meeting will be held September 17, 2020. The NAIC recently released "The Regulators" podcast on Race & Insurance and posted an open position for an NAIC Diversity Officer.

SOFE Editor's Note: This article was originally published by Johnson Lambert LLP on its website on September 11, 2020. For the original versions of the article, please visit https://www.johnsonlambert.com/post/naic-2020-summer/. Reprinted with permission.

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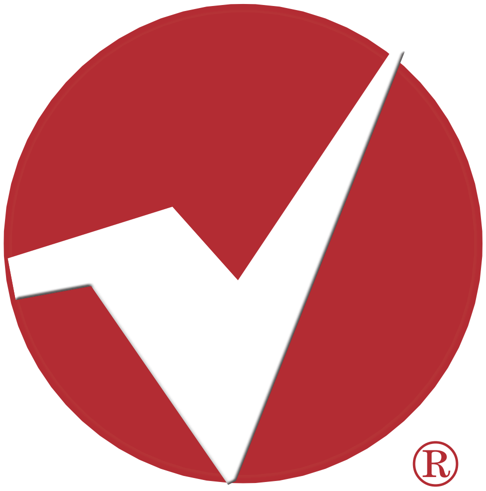

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