Insurance Board

A Tumultuous First Half of the Year - Now What?
Mid-year review
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Key Focus Areas for Insurance Boards

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We see five areas of primary focus for insurance boards here past the mid-way mark of 2022:

1. Assessing Exposures Created by Russia-Ukraine War Sanctions

With insurance being the connective tissue of global commerce, insurance boards are overseeing how their management teams are handling the mounting complexities presented by the possibly of an insurance company running afoul of sanctions imposed on Russia as a result of its war with Ukraine.

In ongoing conversations with insurance board members, we have learned that a base-line concern shared by many board members is whether management has the adequate tools and personnel to identify and assess possible exposures.

Beyond exposure risk, boards are asking management whether reserves are adequate to cover potential losses – or to pay possible penalties if sanction rules are violated.

In many cases boards also are focused on whether management has a transparent view of any of its insureds’ exposures created by a joint venture or any other type of business alliance. What measures are being employed to gain visibility into these business structures, and are the estimates and assessments already done by management adequate?

The list of questions being posed by boards is long - and growing - as the conflict continues and government officials step up their monitoring efforts involving trade with nations, businesses, and individuals on sanction lists.

Boards will want assurance that management has asked and answered questions such as: Are we certain our investment activities are in compliance? Do we know whether we can underwrite a policy for a particular business because of its relationships with certain other businesses or people?

All of these questions may have implications for whether the industry contracts or expands in the months and perhaps years ahead.

As a means to gather intelligence on the web of business structures and alliances, KPMG uses a method that creates a map of relationships that can help insurers identify sanction risks.

An area of particular concern for insurance board members may be whether the business can obtain adequate reinsurance in the face of current issues and uncertainties. Industry analysts at S&P Global Ratings recently said that reinsurers in specialty lines, such as war risk, political violence, and cyber risk, may face vulnerability.1

S&P estimated that losses in the specialty insurance market could reach $35 billion in 2022 due to the Russia-Ukraine war. “These include possible aviation insurance losses totaling $6 billion to $15 billion, depending on scenarios. Other specialty lines likely to be affected by the conflict include cyber, political risk and marine war insurance.” The analysts’ report also included a negative global reinsurance sector outlook, “reflecting ongoing challenges to meet cost of capital, worsened by first-quarter natural catastrophe losses, the Russia-Ukraine conflict, and rising inflation”.2

1 “Russia-Ukraine War Adds to a Bumpy Start to 2022 for Global Reinsurers”, Middle East Insurance Review, May, 2022
2 Ibid
2. Financial Reporting: LDTI and IFRS-17; Complexity and Opportunity

What were once far-off accounting-rule changes related to long-duration contracts and reserves recognition are now upon us. And, while they bring complexity, they also offer a chance to create vast business- and operational-model improvements through advanced data management techniques.

Without question, insurance boards should probe management on whether their businesses are prepared to comply with the new standards.

But, perhaps more important, boards have an opportunity to help guide the use of advanced, technological approaches to meet the challenges associated with the accounting for insurance contracts under U.S. GAAP’s long-duration targeted improvements (LDTI) and IFRS-17.

These standards may be the most demanding financial reporting changes for insurers in decades – especially for insurers doing business globally. At the same time, we may look back on them in the years ahead as the impetus that accelerated the modernization of insurance business processes.

Done well - and with a long-term vision - actuaries, finance-department specialists, C-level executives, and other key figures across an insurance enterprise can not only comply with these standards but also integrate modern technologies to create tangible business value. For those who have only done the minimum, they most likely will have considerable work to do post-implementation to create a more effective and sustainable process.

Boards have a chance to help management create a culture of cross-functional teamwork that speeds up processes and has the potential to improve profitability through cost reduction. Will these accounting standards be the devices that knock down silos and integrate data-management processes across business units? Time will provide that answer.

One thing will be certain, however: Shrewd board members can play an important role in helping management understand their duty to go far beyond simply meeting reporting requirements. Management will use these requirements as a springboard to create digitally powered operations. They will, for example, build a digitized finance function that will be fit for the future, acting as a vital agent that assimilates strategic activities affecting such critical data-intensive areas as actuarial functions, investment activities, and risk management.

While speed and accuracy are today’s imperatives, a newly reengineered organization also can engender trust among shareholders, regulators, and other critical stakeholders.

In the near term, directors should request frequent information in order assess their organization’s plans for LDTI and IFRS-17, including information about the scope of the plans, the distribution of risk, methods for calculating methods for risk adjustments, and disclosure methods among other material.
3. Climate Change and Coverage Considerations

With the impacts of climate change negatively affecting insurance business’s profitability due to more frequent and more extreme weather events, insurance boards are asking, as part of their consideration of strategy and risk, more pointed questions about where insurance companies are offering coverage.

In the past several years, in areas prone to flooding and wildfire – Florida and California, for example – insurance companies have either stopped offering coverage in some regions or hiked premium prices considerably.

Not long ago, home insurance businesses in the United States notified thousands of its customers that their home policies would not be renewed in 2022. Having replacement coverage would carry a cost of up to five times the price of the cancelled policies and the coverage would be more limited than in the past. ³

In Florida, flooding and wind-damage risks, along with escalating instances of litigation and the associated costs, have resulted in some insurance companies canceling policies, limiting coverage, and raising premiums by double digits. Other insurance companies are leaving Florida altogether or have gone out of business, leaving property owners scrambling for coverage just as storm season is about to officially begin.

"Florida’s property insurance market is collapsing. That's the best way we can describe it. It is a mess beyond proportions," Mark Friedlander, director of corporate communications with the Insurance Information Institute, said in a recent radio interview.⁴

The business conditions in these and other geographic locations where severe weather has caused widespread property damage are giving pause to insurance boards and management.

Overall, though, Americans haven't stopped moving into areas at high risk of climate-related disasters, according to a recent report from the National League of Cities (NLC), released in April 2022. The NLC report said that people will "move into risky areas because they've been priced out of their home cities, but sometimes they're looking for more space, solitude, or warmer weather. Either way, the trend means more Americans will face extreme weather disasters, along with the pressure to evacuate or move"⁵.

The migration has created cause for thorough reviews by insurance companies and their boards about pricing and the prospects for doing business in these areas.

Litigation cost is a major reason for withdrawing from certain markets. In 2019, for example 1 in 12 insurance claims by homeowners nationwide were made in Florida. Yet 3 of 4 lawsuits related to claims denials filed nationwide were in Florida.⁶

In our view, as an insurance board monitors their organization’s climate agenda, it should consider the following:

- What inputs are used when management factors climate-related trends into the company’s business model and strategic plans?
- Is the company’s position on climate aligned with its purpose and values?
- Does management incorporate evolving stakeholder interest in climate change as a lens for innovation and growth?
- In considering the company’s risk appetite and processes, it is vital to understand how management integrates climate into risk assessment. Is the enterprise risk management process designed to capture long-term (five years or longer) risk as well as shorter-term impacts?

³ "Wildfire Risk in California Drives Insurers to Pull Policies for Pricy Homes," The Wall Street Journal, January 19, 2022
⁵ “Despite Mounting Danger, Americans Keep Moving to the Counties at Highest Risk for Wildfire, Floods, and Droughts,” Business Insider, April 22, 2022
⁶ Ibid
4. ESG Moving up Board Agenda

Environmental, Social, and Governance (ESG) matters continue to move up the board agenda creating more pressure on management teams to provide stakeholders with more specific information about their ESG strategy.

Board engagement is intensifying as insurance sector stakeholders – employees, customers, regulators, investors, industry analysts, and credit-ratings agencies—become more vocal in demanding that insurers take into account ESG factors in their underwriting, investing, and day-to-day operational activities.

Specific evidence about ESG practices is still difficult to unearth in the public domain when it comes to the material activities of insurers, namely underwriting and investing. It appears only a small percentage of insurers use, or consistently apply, a specific ESG framework or methodology when reporting. The main reason for this is that while there are many ESG frameworks available, there is not enough specificity to allow consistent application. We have seen immense progress over the last 18 months when it comes to ESG reporting in the Insurance industry, but comparability between insurers remains difficult. Board members will need to press for more clarity on this topic as the chorus from stakeholders is not expected to dissipate.

Insurers will have differing goals and aspirations in this area. In our view, however, insurers must be clear when stating their ESG goals and providing details about the path to achieve them, including how ESG efforts will be measured and reported. In most of the ESG frameworks and proposed legislation to date, the board has a significant oversight role to play.

We reported last year that KPMG has conducted two separate surveys on ESG. The first focused on trying to understand whether any of 131 insurers based in 37 countries submitted ESG reports to a third party for an assurance review. The second survey, which polled 67 insurers from the Americas, Europe and Asia Pacific, sought to understand the percentage of the insurers in the surveys considered their organization ESG market leaders, fast followers, or if they felt their business was still at the starting line.

Even though the survey occurred a year ago, the findings provide context for how companies approach this important aspect of their businesses.

Findings from the first survey of 131 insurers revealed that a vast majority - 107 insurers - in the survey said they “report” on ESG efforts. When we analyzed those reports, however, we learned that only 23 of them – or 18 percent – issued a report where only a portion of it underwent some type of a reasonable assurance process by a third party.

Analysis of the second research study discovered that only 15 percent of insurers in the survey considered their business are “very knowledgeable” on ESG issues and were far along in their ESG maturity journey. Fifty-eight percent of insurers in the survey reported being at the starting line with a “lack of awareness of key ESG issues” for the industry or understanding what competitors were doing."

While progress has been made on a number of fronts as regards ESG reporting, it still appears that insurers’ ESG reports too often contain high-level statements about a commitment to a better environment, social justice, and robust governance standards. At the same time insurers have stated bold ambitions to provide stakeholders with clear, concise, and measurable ESG reports, none however provide reports that have been fully assured by an independent third party.

A reason for this situation may be that “clear and uniform reporting standards are still in their infancy stage as regulations and investor preferences evolve8. That being said, the regulatory landscape is changing quickly and radically with regulators and legislators such as the SEC, NAIC, International Standards Sustainability Board (ISSB), European Financial Reporting Advisory Group (EFRAG) driving forth with proposed rules around ESG reporting.

And while some of this rule making may seem off on the horizon there is little stopping boards from taking the lead and demand that current ESG reporting undergo an assurance review by an independent third party.

Our research indicates that insurers have a significant opportunity to be more relevant to stakeholders by articulating the material ESG topics to their stakeholders. Doing so will likely improve investment returns, operational performance, have comparatively lower cost of capital to peers with lesser ESG ratings, and improve customer and regulatory relationships. In short, by addressing stakeholder concerns around ESG, management teams will improve shareholders’ and stakeholder value.

7 “KPMG internal research
8 Ibid
9 “A Brief Introduction to the GRI Reporting framework,” June 29, 2021, Goby, Inc.”
5. Be Proactive, Not Reactive, in the Search for Technical Talent

Boards must play an aggressive role as insurers – along with other businesses – face the expanding need for tech-savvy talent as an integral part of the business’s digital innovation program.

Indeed, board members must press management about whether proactive programs are in place to assess whether the potential for key talent gaps exist in areas where technical skills are essential. Increasingly, those skills are in high demand in the financial reporting realm where deficiencies or material weakness can pose serious threats to reporting controls.

The “Great Resignation,” so often cited this past year as being a contributor particularly to the technology gaps, provides a tangible reason for boards to press management about specific strategies to address this pain point.

Insurance board members would serve their organization well by focusing questions about whether management has succession plans in place in such key areas as the broad finance function, and in specific areas such as internal audit. The audit committee should be asking and assessing the external auditor’s staffing and technical capabilities directly.

What’s more, a continuous focus on potential turnover in these key areas can help avoid poor performance relating to financial reporting risk and controls.

According to life insurance trade association LIMRA, a tech-skills gap already had created a need for insurers to innovate digitally before the pandemic hit and the “Great Resignation” surfaced. Two-thirds of life insurance executives surveyed by LIMRA said embracing digital innovation would be most important to the future of work in the industry. But the survey also revealed that to reach that goal insurers will need to recruit or train new types of workers to handle data analytics duties, increase the number of available actuaries, and hire more technology professionals.¹⁰

The upshot is that insurers also will need to up-skill and re-skill current employees to address tech needs as the elimination of manual processes is ongoing.

While it is management’s job to make all of that happen, board must have robust discussions about these vital challenges.

There may be a need to entice outsiders into the insurance fold as well as retain existing personnel. Pro Benefits Magazine reported in November of 2021 that three quarters of people they polled expect employers to expand non-medical benefits as workforce dynamics continue to change in the post-pandemic world. Specifically, employees said they hope employers would offer career development support, along with financial, mental, and physical wellness programs.

And employers apparently are listening:
“Employers see benefits as a necessary tool to be able to compete in the war for talent. Despite 54 percent of employers reporting a decrease in revenue in the last year, the vast majority are not planning to cut back on benefits, and almost half are considering offering a customized menu of benefits to help attract and retain talent.”¹¹

Insurance board members need clarity on management’s plan in this regard, and they should seek specificity on such plans if answers to such questions are vague. The report on the expectation of more non-medical benefits highlighted a critical area for review: “Employees are looking for clearer information and recommendations about the benefits best suited to them,” and that “employers’ current education approaches fall short.”¹² The survey results said respondents cited “multiple challenges to understanding, from lack of time and overall benefit complexity to insufficient or poorly communicated information.”¹³

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¹⁰ Insurers Face Challenges With Acquiring Talent in 2022,” Insurance News Net Magazine, February 1, 2022
¹¹ “Demand for Non-Medical BENEFITS Expected to Grow 20% in the Next Five Years,” Benefits Pro Magazine, November 17, 2021
¹² Ibid
¹³ Ibid