Corporate Governance and Market Discipline

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ICP 9 Corporate Governance

- The corporate governance framework should recognise and protect the rights of all interested parties. The supervisory authority should require compliance with all applicable corporate governance standards

Other related Insurance Core Principles

- Suitability of persons (7)
- Internal control (10)
- On-site inspection (13)
- Risk assessment and management (18)
- Information disclosure (26)

Definition of Corporate Governance

- The manner in which boards of directors and senior management oversee the business and affairs of insurers. It encompasses the means by which they are held *accountable* and *responsible* for their actions. It includes corporate discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. Timely and accurate disclosure on all material matters regarding the insurer, including the financial situation, performance, ownership and governance arrangements, is part of such a framework. Corporate governance also includes compliance with legal and regulatory requirements.

Rationale

- Financial institutions are exposed to risk
  - Decrease the risk of unexpected losses
  - Efficiency creates value and core competencies
- Competitive environment
  - Ensure that the goals and objectives are met
  - Decrease the risk of damage to the insurers reputation
- Client have a claim on the institution for future payment
  - Create confidence in the ability to meet the obligations
- Facilitate compliance with rules, policies and plans
- Oversight activities of supervisors is not enough

Causes of recent failures*

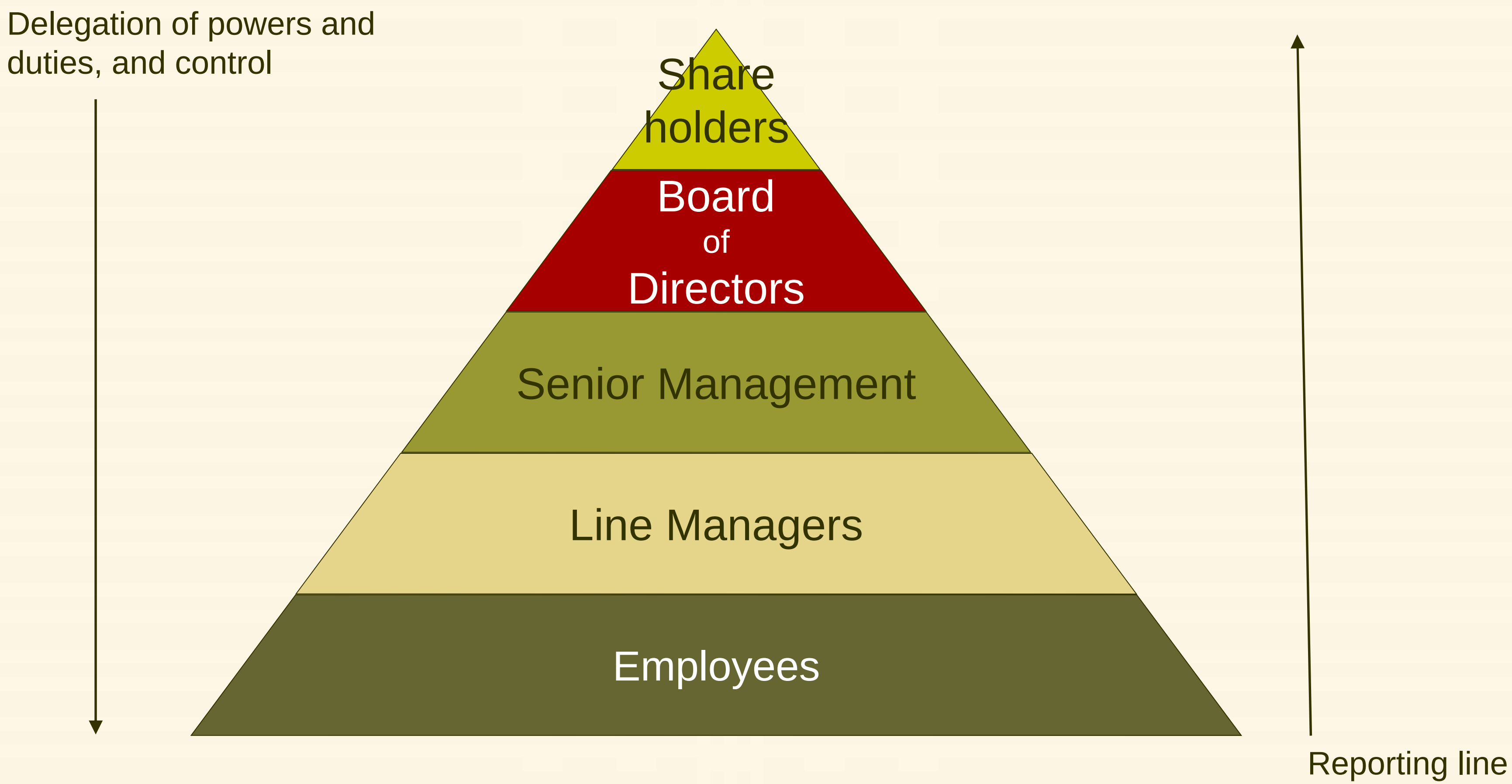
- Management problems
  - Groups (conflicting or irrelevant objectives)
  - Lack of skills or integrity
- Interactions and correlations of different risks were not anticipated or assessed
- Poor control
  - Mergers and acquisitions
  - Outsourced key functions

* London Report

Clear lines of responsibility and accountability

- Define the authorities and key responsibilities for board of directors and senior management
- Create an accountability hierarchy for the staff
- Take into consideration that the ultimate responsibility stays with the board

Corporate structure



Strategic objectives and corporate values

- Define a well articulated corporate strategy
- Establish the tone at the top/create a climate that prevents corruption and fraud
- Safeguard the interests of key stakeholders
- Create a system to avoid conflict of interests
- Control lending to officers and employees and other forms of self-dealing
- Ban preferential treatment also to related parties and other favoured parties

Quality, awareness and independence of board members

- Understand oversight role and duty of loyalty
- Avoid conflicts of interest
- Do not participate in day-to-day management
- Provide objective advice
- Recommend sound practices based on experience
- Have power and structure to question management
- Meet with senior management and internal audit
- Assess own and others' performance and take corrective actions

Appropriate oversight by senior management

- Key decisions should be made by more than one person
- Not be too involved in business-line decisions
- Have the necessary prerequisite skills
- Exercise control over key employees

Proper use of auditors

- Recognise the importance of the audit process and communicate it throughout the company
- Take measures to enhance their independence
- Utilise their findings effectively
- Have external audit verify internal controls
- Correct problems identified by auditors
- Use auditors as independent check of information from management

Other control functions

- “Appointed” actuary*
- Compliance officer
  - Proactive (information and education)
  - Reactive (complaints)
  - Know-Your-Customer procedures
- Audit Committee
  - Internal audit and control
  - External audit

* Chief/senior management, Business line/management

The role of the compensation policy

- Smart people who are doing stupid things are often being paid for it
- It is never good to have a system of incentives which you have to resist to avoid going in the wrong direction

Compensation system

Should create the right incentives and be consistent with:

- Ethical values
- Objectives
- Strategy
- Control environment

What about shareholders' responsibilities?

- Majority shareholders
  - Too influential?
- Minority shareholders
  - Too passive?

Market discipline

- Financial markets should be sound, stable and effective
- Market forces can raise the cost or restrict the volume of funding
- Market forces can deter excessive risk taking and inappropriate behaviour
- Markets are vulnerable to reputational risk
- Market discipline promotes financial stability

Provided that…………..

Disclosure of information and dialogue

Markets participants need to have

- Sufficient information to reach informed judgements
- The ability to process it correctly
- The right incentives
- The right mechanisms to exercise discipline

ICP 26 Information, disclosure and transparency towards the market

Supervisory authorities should require insurers to:

- Disclose relevant information on a timely basis in order to give stakeholders a clear view of:
  - Business activities
  - Financial position
  - Risks to which they are exposed

This would also include

- Board and senior management structure
- Basic organisational structure
- Incentive structure
- Nature and extent of transactions with affiliates and related parties

This could also include

- Off-balance sheet transactions
- Significant risk exposures, their effects and how they are being managed and controlled
- Compliance

Internal transparency

- Visible operations, activities, risk exposures
- Clearly defined responsibilities, processes
- Risk disclosure and dialogue among business groups, corporate centre, executive board and board of directors

Enhanced transparency

- Financial reports should reflect the “true” financial condition
- “True” information requires good internal control and due diligence
- CEOs and CFOs should be aware of all operational information that is material to the financial results of their companies
- Requiring them to certify the information disclosed would promote better internal control and due diligence
- Limit the scope of non-audit and consulting services for audit firms (conflict of interests)

Enhanced responsibilities

- Enhanced liability and criminal sanctions promotes enhanced analysis and transparency
- Enhanced duties and responsibilities also for third party advisors, such as lawyers, banks etc?

How to address management related problems?

- Use regulatory and supervisory tools available
- Prevent and identify at the earliest possible stage
- Good corporate governance can prevent some problems and promote early detection
- Require good corporate governance - easier to define than establish (no one-size-fits-all) - outline scope and monitor implementation

Type of framework

- Prescriptive rules
- Guidelines
- Self regulation
- Enforcement mechanism

Conclusions

- Insurers, policyholders, supervisors and market participants have an interest in sound risk management and corporate governance practices
- Sound practices need enforcement mechanisms
- Not purely self-regulated
- Establish a regulatory framework *and* monitor the effectiveness of the codes in their appliance