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ENHANCING CORPORATE GOVERNANCE IN THE INSURANCE SECTOR: PRACTICES AND PERSPECTIVES

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Abstract

Corporate Governance is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization. The Insurance Regulatory and Development Authority (IRDA) has outlined in general terms, governance responsibilities of the Board in the management of the insurance functions under various Regulations notified by it covering different operational areas. It has now been decided to put them together and to issue the following comprehensive guidelines for adoption by Indian insurance companies. These guidelines are in addition to provisions of the Companies Act, 1956, Insurance Act, 1938 and requirement of any other laws or regulations framed there under. Where any provisions of these guidelines appear to be in conflict with the provisions contained in any law or regulations, the legal provisions will prevail. However, where the requirements of these guidelines are more rigorous than the provisions of any law, these guidelines shall be followed.The guidelines accordingly address the various requirements broadly covering the following major structural elements of Corporate Governance in insurance companies.

Key Words: Governance structure, Board of Directors, Control functions, Senior management, Disclosures, Outsourcing, Relationship with stakeholders, Interaction with the Supervisor.

INTRODUCTION

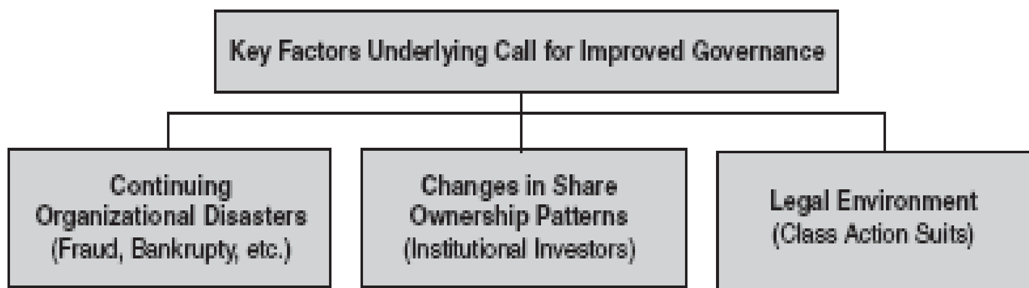
In Asian countries, particularly newly industrializing economies, more attention needs to be paid to the corporate governance problem arising from the separation of control from ownership. With most large corporations owned and controlled by families and with family members holding key managerial positions, however, the major agency problem exists not between the management and owners in general, but between the management (the controlling family) and minority shareholders. The existence of large shareholders may by itself not be a matter of concern, or may even be a blessing, but the beneficial effect of large shareholders should be expected only when management is separated from ownership or when proper corporate governance mechanisms are in place so that outside shareholders can effectively check misbehavior by controlling owners. These conditions are generally not met

in most Asian enterprises. The agency problem between controlling and outside shareholders is potentially serious, particularly for large firms with many subsidiaries.

Poor corporate governance has been widely viewed as one of the structural weaknesses that were responsible for the onset of the 1997 Asian financial crisis. Family-controlled large businesses have indeed been inadequately supervised or monitored by outside shareholders, boards of directors, creditor banks, or markets for corporate control. Corporate management has lacked transparency because of inadequate accounting and disclosure standards. In managing their firms and business groups, controlling family owners have been able to pursue their private interests relatively easily, often at the expense of minority shareholders and their firms' profits. Even though economic growth in some of the crisis-hit Asian countries rebounded strongly despite seemingly limited progress in improving corporate governance, this should not be taken as evidence that corporate governance matters little. Without strengthening corporate governance, economic growth is unlikely to be sustainable and may be vulnerable to another crisis in the future.

CORPORATE GOVERNANCE

Corporate Governance is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs.



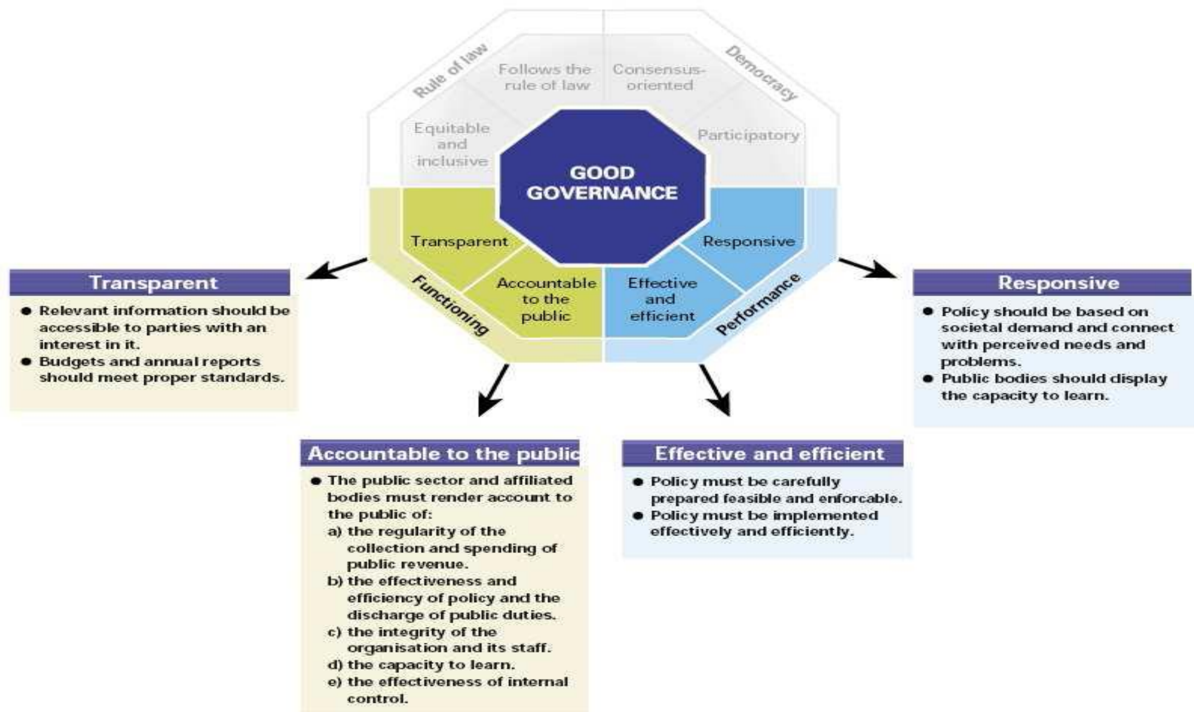
Demand for Governance

Corporate Governance is understood as a system of financial and other controls in a corporate entity and broadly defines the relationship between the Board of Directors, senior management and shareholders. In case of the financial sector, where the entities accept public liabilities for fulfillment of certain contracts, the relationship is fiduciary with enhanced responsibility to protect the interests of all stakeholders. The Corporate Governance framework should clearly define the roles and responsibilities and accountability within an organization with built-in checks and balances. The importance of Corporate Governance has received emphasis in recent times since poor governance and weak internal controls have been associated with major corporate failures. It has also been appreciated that the financial sector needs to have a more intensive governance structure in view of its role in the economic development and since the safety and financial strength of the institutions are critical for the overall strength of the financial sector on which the economic growth is built upon. As regards the insurance sector, the regulatory responsibility to protect the interests of the policyholders demands that the insurers have in place, good governance practices for maintenance of solvency, sound long term investment policy and assumption of underwriting risks on a prudential basis. The emergence of insurance companies as a part of financial conglomerates has added a further dimension to sound Corporate Governance in the insurance sector with emphasis on overall risk management across the structure and to prevent any contagion.

Report of SEBI committee (India) on Corporate Governance defines corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company." The definition is drawn from the Gandhian principle of trusteeship and the Directive Principles of the Indian Constitution. Corporate Governance is viewed as ethics and a moral duty.

PRINCIPLES OF GOOD CORPORATE GOVERNANCE

Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization.



Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness. In particular, senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports. Commonly accepted principles of corporate governance include:

Rights and equitable treatment of shareholders: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.

Interests of other stakeholders: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

Role and responsibilities of the board: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors.

Integrity and ethical behaviour: Ethical and responsible decision making is not only important for public relations, but it is also a necessary element in risk management and

avoiding lawsuits. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that reliance by a company on the integrity and ethics of individuals is bound to eventual failure. Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

Disclosure and transparency: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information. Issues involving corporate governance principles include:

Internal controls and internal auditors

The independence of the entity's external auditors and the quality of their audits

Oversight and management of risk

Oversight of the preparation of the entity's financial statements

Review of the compensation arrangements for the chief executive officer and Other senior executives

The resources made available to directors in carrying out their duties

The way in which individuals are nominated for positions on the board

Dividend policy

CORPORATE GOVERNANCE IN INSURANCE SECTOR

The Insurance Regulatory and Development Authority (IRDA) has outlined in general terms, governance responsibilities of the Board in the management of the insurance functions under various Regulations notified by it covering different operational areas. It has now been decided to put them together and to issue the following comprehensive guidelines for adoption by Indian insurance companies. These guidelines are in addition to provisions of the Companies Act, 1956, Insurance Act, 1938 and requirement of any other laws or regulations framed there under. Where any provisions of these guidelines appear to be in conflict with the provisions contained in any law or regulations, the legal provisions will prevail. However, where the requirements of these guidelines are more rigorous than the provisions of any law, these guidelines shall be followed.

The guidelines accordingly address the various requirements broadly covering the following major structural elements of Corporate Governance in insurance companies:-

1. Governance structure
2. Board of Directors
3. Control functions
4. Senior management
5. Disclosures
6. Outsourcing
7. Relationship with stakeholders
8. Interaction with the Supervisor
9. Whistle blowing policy

Governance Structure

Currently, the private insurers in India are yet to go public and get their shares listed on the stock exchanges. The composition of the Boards of the Public Sector Undertakings in the insurance sector is also laid down by the Government of India. It is relevant to observe here that the Corporate Governance requirements of companies listed in the Stock Exchanges have

evolved over time and are outlined in Clause 49 of the Listing Agreement of the Stock Exchanges. As the listing requirements are available in public domain they are not being repeated. The Indian insurance companies are as yet unlisted but the Authority advises all insurers to familiarize themselves with Corporate Governance structures and requirements appropriate to listed entities. The companies are also well advised to initiate necessary steps to address the extant "gaps" that are so identified to facilitate smooth transition at the time of their eventual listing in course of time.

Board of Directors

- The Insurance Act stipulates that the insurance companies in India would be **public companies** and hence, would require a properly constituted Board.
- Insurers should ensure that the Board comprises of competent and qualified Directors to drive the strategies in a manner that would sustain growth and protect the interests of the stakeholders in general and policyholders in particular.
- The size of the Board in addition to being compliant with legal requirements (where applicable), should be consistent with scale, nature and complexity of business. The size and composition should ensure that they collectively provide knowledge, skills experience and commitment along with independence. Further, the Board Members should be in a position to dedicate sufficient time and commitment to fulfilling their responsibilities.
- It is expected that the shareholders of the companies elect or nominate Directors from various areas of financial and management expertise such as accountancy, banking, insurance, economics etc., with qualifications and experience that is appropriate to the company.
- It is essential that the Directors possess the knowledge of group structure, organizational structure, process and products of the insurer and the Board generally complies with the following requirements:-
    - The Board of Directors and Senior Management understand the operational structure of the insurer and have a general understanding of the lines of business and products of the insurer, more particularly as the insurer grows in size and complexity.
    - The Board of Directors of an insurer belonging to a larger group structure/ conglomerate should understand the material risks and issues that could affect the group entities, with attendant implication on the insurer.
- The Board of Directors is required to have a significant number of "Independent Directors" (as generally understood). The optimum contribution of Independent Executive and Non-Executive Directors enhances the quality of business judgment and benefits the shareholders and policyholders. At a minimum, where the company has a non-executive Chairman, at least fifty percent of the directors should be independent and in other cases at least one third of the directors should be independent. This is especially important in respect of insurance companies under conglomerate structure and where there is potential scope for transfer of risks and conflicts of interests that affect the group entities.
- Similarly, where the Chairman of the Board is non-executive, the Chief Executive Officer should be a whole time director of the Board.
- As a matter of prudence, not more than one member of a family or a close relative as defined in the Companies Act or an associate (partner, director etc) should be on the Board of an Insurer.
- Procedures concerning election, re-election, removal and retirement of members of the Board of Directors should be set out and documented.

Control Functions

Given the risks that an insurer takes in carrying out its operations, and the potential impact it has on its business, it is important that the Board has in place:

- Robust and efficient mechanisms for the identification, assessment, quantification, control, mitigation and monitoring of the risks;
- Appropriate processes for ensuring compliance with the Board approved policy, and applicable laws and regulations;
- Appropriate internal controls to ensure that the risk management and compliance policies are observed;
- An internal audit function capable of reviewing and assessing the adequacy and effectiveness of, and the insurer's adherence to its internal controls as well as reporting on its strategies, policies and procedures; and
- Independence of the control functions, including the risk management function, from business operations demonstrated by a credible reporting arrangement.

Senior Management

The Chief Executive Officer of the company and other key functionaries are responsible for the operations and day to day management of the company in line with the directions of the Board and the Committees set up by the Board. Section 34A of the Insurance Act, 1938 requires prior approval of the Authority for appointment, re-appointment or termination of the Chief Executive Officer and the Whole Time Directors. The Authority expects the CEO to be responsible for the conduct of the company's affair in a manner which is not detrimental to the interests of the policyholders and is consistent with the directions of the Board. The Board should, therefore, carry out effective due diligence to establish that the new incumbent is 'fit and proper' before recommending the name for Authority's approval.

As the appointment of the CEO is made with the prior approval of the IRDA the Board should take proactive steps to decide on the continuance of CEO well in time before the expiry of his tenure or to identify the new incumbent. The Authority requires the proposal to be submitted with the approval of the Board at least a month before the completion of the tenure of the incumbent. As a corollary, the Board should also have practices in place for succession planning for the key senior functionaries through a process of proper identification and nurturing of individuals for taking over senior management positions.

Disclosure Requirements

The prescriptions on financial disclosures in the financial statements are laid down in the IRDA (Preparations of Financial Statements) Regulations, 2002. In addition, the Authority is in the process of finalizing additional disclosures to be made to it and generally to the public at large at periodical intervals. Once these disclosure requirements are finalized, all insurers would be required to ensure compliance thereof.

a) The Board should disclose in the annual accounts of the insurer, information on the following including the basis, methods and assumptions on which the information is prepared and the impact of any changes therein: Quantitative and qualitative information on the insurer's financial and operating ratios, namely, incurred claim, commission and expenses ratios.

b) Actual solvency margin details vis-à-vis the required margin.

c) Life insurers shall disclose policy lapse ratio.

d) Financial performance including growth rate and current financial position of the insurer

e) A description of the risk management architecture

f) Details of number of claims intimated, disposed of and pending with details of duration

g) All pecuniary relationships or transactions of the non-executive directors vis-à-vis the insurer shall be disclosed in the Annual Report.

h) All elements of remuneration package of individual directors summarized under major groups such as salary, benefits, bonuses, etc shall be disclosed.
i) All related party transactions.
j) Any other matters, which have material impact on the insurer's financial position.

Outsourcing

The IRDA (Registration of Insurance Companies) Regulations, 2000 requires that the insurer should be able to carry on all functions in respect of insurance business including management of investments within its own organizations. An insurer shall not, therefore, outsource any of the company's substantive functions other than those that have been explicitly permitted. Each proposal to outsource any function of the insurer as permitted by the Authority (e.g., as in the case calculation of NAV of Investments) shall be reported to IRDA before entering into the arrangement. Where the IRDA issues any guidance in the matter, it shall be complied with. All outsourcing arrangements of the company shall have the approval of the Board. Every outsourcing contract shall contain explicit safeguards regarding confidentiality of data and all outputs from the data, continuing ownership of the data with the insurer and orderly handing over of the data and all related software programmes on termination of the outsourcing arrangement. The arrangement shall be for a defined duration of not more than 3 years and should have provision for premature cancellation without attracting penalties.

1. The Board shall monitor and review the performance of agencies to whom operations have been outsourced at least annually.

2. The Authority reserves the right to access the operations of the outsourced entity to the extent these are relevant to the insurance company.

Relationship with Stakeholders

A stakeholder is any person, group or organization that has a direct or indirect stake in an insurer. The stakeholder can affect or be affected by the insurer's actions, objectives and policies.

Towards protecting the interests of the various stakeholders the insurer must ensure complete transparency in operations and make periodic disclosures. The disclosures stipulations must at the minimum address the following:

- Financial statements accurately and fairly represent the financial condition of the insurer; and
- The insurer is running its business soundly and will be viable over the long term.

In particular, the disclosure requirements of the participating policyholders and the unit linked policyholders must be duly addressed.

In case of a situation arising whereby there is a possibility of conflict of interests, the board plays an important role and balances and resolves the conflicting objectives. The board must be guided by clear and understandable principles. It must ensure protection of the interests of both current and prospective policyholders.

Interaction with the Supervisor

Effective corporate governance practices in the office of the insurer will enable IRDA to have greater confidence in the work and judgement of an insurer's board, senior management and control functions.

In assessing the governance practices in place, the IRDA would:

- Seek confirmation that the insurer has adopted and effectively implemented sound corporate governance policies and practices;
- Assess the fitness and propriety of board members;
- Monitor the performance of boards;

- Assess the quality of insurers' internal reporting, risk management, audit and control functions;
- Evaluate the effects of the insurer's group structure on the governance strategies;
- Assess the adequacy of governance processes in the area of crisis management and business continuity.

The IRDA would, at periodic intervals, also bring to the board's and senior management's attention problems which have been detected through supervisory activities.

Whistle Blowing Policy

The insurers are well advised to shall put in place a "whistle blowing" policy; where by mechanisms exist for employees to raise concerns internally about possible irregularities, governance weaknesses, financial reporting issues or other such matters.

The Policy illustratively covers the following aspects:

- Awareness of the employees that such channels are available, how to use them and how their report will be handled
- Handling of the reports received confidentially, for independent assessment, investigation and where necessary for taking appropriate follow-up actions
- A robust anti-retaliation policy to protect employees who make reports in good faith
- Briefing of the board of directors.

The appointed actuary and the statutory/internal auditors have the duty to 'whistle blow', i.e., to report in a timely manner to the IRDA if they are aware that the insurer has failed to take appropriate steps to rectify a matter which has a material adverse effect on its financial condition. This would enable the IRDA to take prompt action before policyholders' interests are undermined.

CONCLUSION

Good corporate governance is a must for today's complex and dynamic business environment to ensure long-term sustainability. So, it should be cultivated and practiced regularly within the current structure of the business. We may institute international awards for good corporate behavior, and promote a global corporate governance ranking system for Fortune 500 corporations and alike. If, as corporations, we ignore the lessons that companies like Enron, WorldCom and Tyco have to offer, we will fail to regain the public trust that is so essential to our long-term success and survival. Corporations that genuinely recognize and embrace the principles of 'good governance' will derive enormous benefits, the availability and lower cost of capital, the ability to attract talent clients and business partners, improved competitiveness and financial performance, and truly sustainable long term growth. And, undoubtedly, accounting will show us the way to proceed with corporate governance where bad governance generally comes from financial dissatisfaction and over exercising of power.