FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

Case Study on Corporate Governance – What Went Wrong and Who Were to Blame

Regional Seminar for Supervisors in Africa on Risk-based Solvency and Supervision

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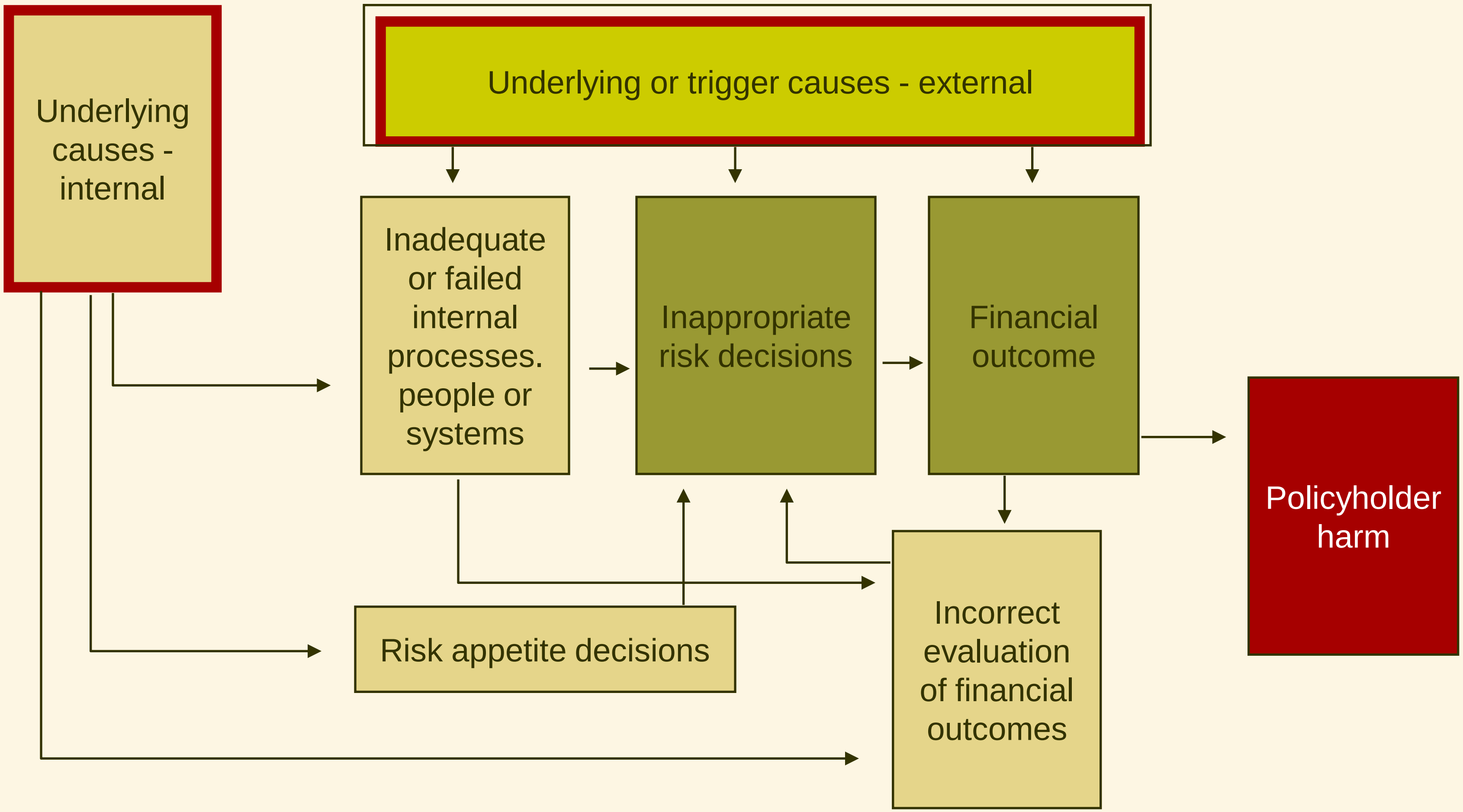
Situations that should alert a supervisor

- Threats to insurers' continued solvency
- Insurers failing to operate in a manner that is consistent with sound business practices or regulatory requirements
- Insurers failing to provide information or providing information intended to mislead
- Management ignoring more informal requests from the supervisor to take corrective actions

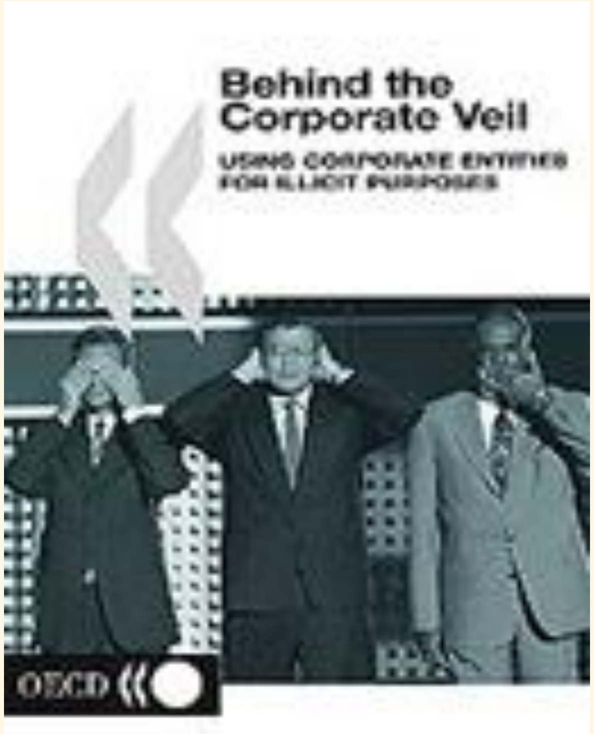
Where to start – starting early



Brief introduction to international corporate governance standards and sound practices

Corporate governance is always at the forefront

- HIH
- Northern Rock
- Bear Stearns
- Lehman Brothers
- AIG
- The financial crisis



Corporate governance is essential

- Critical role and exposure to risk
  - Decreases the risk of *unexpected* losses (increasing complexity)
  - Efficiency creates value (micro and macro level)
- Competitive environment
  - Ensure that the goals and objectives are met
  - Decrease the risk of damage to the insurers' reputation
- Inter-linkages
  - Decrease the risk of contagion and damage also to others' reputation
- Customer claims on the institution for future payment
  - Create confidence in the ability to meet the obligations
- Compliance with rules, policies and plans
  - Effective oversight framework facilitates compliance with detailed and complex requirements
- Supports supervisory objectives of sound, safe, stable and efficient markets

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*

* *IAIS Insurance Core Principles*

Other sources: *IAIS/OECD, Issues Paper on Corporate Governance (2009)*

Basel Committee on Banking Supervision, Consultative Document on Principles for Enhancing Corporate Governance (2010)

Foundation of corporate governance

- Corporate culture and environment (values, ethics etc)
- Corporate structures (board, senior management, business area functions etc)
- Governing documents and policies (by-laws, organisational rules, committee mandates etc)
- Strategies, policies, procedures and controls (covering all risks and risk management, compliance, audit and financial reporting)
- Decision making and actions linked to the environment, framework, policies and controls

Shareholders' interests and responsibilities

- Corporate governance practices were initially designed to protect shareholders' *interests*, ie balance potential conflicts of investors (outsiders) and those who control the company (insiders)
- Supervisors need to take an interest in investors (capital base is solvency buffer) but should focus on the interests of the policyholders (ICP 9 applies to all insurers irrespective of organisational form, i.e. also mutual companies)
- Shareholders also have *responsibilities*
- Majority shareholders
  - Leave some independence
- Minority shareholders
  - Sufficient focus on accountability

Corporate governance is about people

- Focus on those who can make a difference and to whom it makes a difference
- Key functionaries and stakeholders:
  - Insiders, who have the information and can take decisions and influence the outcome
  - Outsiders, who have a vested interest in the outcome of the decisions
- Suitability of significant owners and key functionaries
- Protection of shareholders, future investors, policyholders and employees

Building-blocks of sound standards and practices

Hierarchy with clear lines of responsibility and accountability	Strategic objectives and corporate values	Quality, awareness, knowledge and independence of board members	Appropriate oversight by senior management
Know-your-structure	Proper use of internal auditors and internal control functions	Proper compensation policy	Disclosure of information and market discipline

Supervisory interventions and sanctions as prescribed by the IAIS in the Insurance Core Principles (ICP)

ICP 14 Preventive and corrective measures

- Have legal and operational capacity to bring about timely action
- Make use of adequate preventive and corrective instruments that are ***suitable*** and ***necessary*** to achieve the objectives of insurance supervision
- Have a progressive scale of actions and remedial measures
- Have the capacity and standing to communicate with companies and require information

Preventive supervisory tools

- Proactive measures that seek to reduce risk or avoid situations with a negative outcome for policyholders
- Earliest possible intervention
- Example of requirements:
  - Continual fit and proper
  - Sound corporate governance, internal control, and risk management
  - Periodic reporting
  - Disclosure and transparency
  - Business plan and strategy for new business
  - Off- and on-site supervision
- Informal contacts with management

Corrective supervisory measures

Require:

- Compliance with rules and rectification of breaches
- Correction of reporting errors
- Plan of redress (acceptable steps and timetable)
- Capital injection
- Additional or other reinsurance
- Portfolio transfer or merger
- Change of management

ICP 15 Enforcement or sanctions

Formal directions to take (or desist) actions :

- Failure to comply should have serious consequences
- Possibility to combine sanctions with fines against individuals and insurers
- Sanctions are powerful supervisory tools that should be used in a fair and equal manner
- It is not sufficient for supervisors to have powers delegated under legislation – powerful tools are only powerful if used
- Determine that the insurer is complying with the measures once action has been taken or measures have been imposed

Enforcement or sanction measures

- Restrict business activities
  - Stop the writing of new business
  - Withhold approval for new activities or acquisitions
- Direct the company to stop unsound practices
- Direct a company to stop unlicensed business
- Remove directors and managers - bar individuals from acting in responsible capacities in the future
- Require capital levels to be increased
  - Restrict disposal of insurer’s assets
  - Restrict/suspend dividend or other payments to shareholders
  - Compulsory portfolio transfer or conservator ship
- Revoke the licence
- Combine with fines

ICP 16 Winding-up and exit from the market

- Determine when it is no longer permissible to continue business
- Lay down procedure for dealing with winding-up and insolvency (define insolvency)
- Protect the rights and entitlements of policyholders/beneficiaries in the event of insolvency
  - Protection/guarantee fund
  - Preferential rights

Appointing an administrator/liquidator

- Take over the role and duties of the board and senior management
- Before and/or after a winding-up
  - Before: take over the control in order to protect the rights of the policyholders (usually no new business but still supervised)
  - After: Protect the assets to satisfy the interests of all stakeholders (court process with little involvement of the supervisor)

Policyholder protection schemes

- Pool of money (pre- or post-funding by the industry) to be used to meet the obligations of a failed company (predefined classes or lines of business)
- Non-life: claimants / Life: claimants and policyholders
- Payment during winding-up or/and after (whole or remaining part of the claim
- Moral hazard risk
  - Lax supervisory treatment
  - Impudent industry behaviour
  - Less consumer due diligence
- Supervisory decisions and enforcement actions should be taken irrespective of protection scheme

Introduction to the case

- The **Guarantee Life Insurance Company** (**GL**) was one of the largest life insurers in its country. It had around 56 thousand policyholders when it went bankrupt and the liabilities amounted to 620 million, the assets being worth only 230 million. The deficit thus amounted to 390 million or 63 % of the liabilities
- **Questions:** *How could the insurance company end up with such a deficit and who were to blame for this happening? Please examine the owners, senior management, auditors and supervisors/regulators, and explain what they did wrong. Please indicate what you think they should have done differently and at what stage. Please note that the answers do not necessarily need to be directly related to corporate governance.*