

# **CORPORATE GOVERNANCE ISSUES FOR THE INSURANCE INDUSTRY PRESENTATION**

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## **Introduction**

Corporate governance is now a topic of considerable interest to a large and expanding cross-section of our communities. Until fairly recently, corporate governance was not a topic that attracted much public attention. It was a topic reserved for discussion in the Board room or in academic environments. However, recent corporate failures and collapses, such as the Enron, WorldCom and many others, and recently in Zimbabwe the banking sector crisis and other corporate governance failures, have put corporate governance on the front pages of national newspapers. These events leave people wondering whether directors as corporate leaders and monitors, sleep on the wheel, corrupt and fraudulent, ignorant of their role and the onerous responsibility directorships carry.

although no-one welcomes this kind of adverse publicity, it has nonetheless had beneficial effects. In particular, it has highlighted the important role that corporate governance plays in a modern economy and the consequences of getting it wrong. It has also strengthened the incentives for directors and policy-makers alike,

to re-assess the measures needed to produce high quality corporate governance practices. It has accentuated the need for effective, high quality, high performance boards and the need to craft boards with appropriate competencies to ensure continued wealth creation for shareholders and other stakeholders thereby contributing to the success of national economies.

Does corporate governance matter for the insurance industry? Yes there are serious implications for the industry. One can essentially distinguish between direct and indirect effects of the corporate governance debate on the insurance industry. There are those related to the governance of the insurance companies as such and those related to the governance of the companies in which insurers invest or have other business interests in. Corporate governance issues may affect insurers in at least the following ways:

1. General corporate governance concerns: especially corporations listed on Stock Exchanges, they cannot avoid standard governance challenges. Indeed the failure of some insurance companies like HIH

Insurance Group in Australia and the Independent Insurance Group in the UK is attributed to corporate governance failures.

2. Industry specific issues such as: The rights of beneficiaries/policyholders, or the non-corporate i.e. mutual insurers and complex principal-agent relationships. Insurers customers, the policy holders are in principle unsecured financial stakeholders, which is somewhat unique to the insurance business. Is there need to set up a Policyholder protection Fund as a safety net for policyholders?

Others may point to the existence of the Regulator or the Supervisor as a source of solution to CG problems. However this may actually spawn additional problems in that, incentives on the part of shareholders, policyholders and market participants may diminish when that burden is transferred to the regulator.

3. Investment risk: As long term institutional investors, Insurers are themselves a corporate governance instrument. They are expected to demand from companies invested in, compliance with the highest corporate governance standards and monitor such compliance.
4. Corporate governance failures may directly affect insurers' lines of business: Risk assessments in certain insurance lines heavily rely on the corporate governance framework. Examples are Directors and Officers, errors and omissions, surety, financial guarantee,

Professional Indemnity covers ie for Auditors, Actuaries etc.

5. Regulatory risk
6. Litigation risk (as both plaintiff and defendant)

How then could insurance industry players minimise the chances of hitting the newspaper headlines for corporate collapses and failures? Among other factors, the crafting of the board in terms of its composition and competencies and building of effective, high performance boards matters.

### **Corporate Governance Structures**

A look at the published financial statements of nearly all listed companies including those that collapsed show that corporate governance structures and processes are, or were in place. Why and how do these companies go belly up, in the presence of these glorious statements usually on glossy and expensive paper? What it means is that corporate governance structures including the setting up of corporate governance committees is not good enough, it does little to develop a board especially if the board is weak. Policies that are not practised are useless.

The people element, i.e. the competency and character of the directors matter. Even in the so-called developed countries we have seen countless cycles of scandal, reform and rule making. This confirms that the key to excellence is not in the structures in Corporate Governance but in director competencies and

behaviour linked to the corporate strategic needs. This is where we want to focus on today.

Corporate governance is about leadership, leadership that is accountable, transparent with nothing to hide, leadership that is responsible, disciplined and honest. I see corporate governance as a way of life and not like religion. We often put on religious uniform once a week (usually Sundays) and take it off upon return from church and forget about it until the following Sunday.

Given the ever-changing business environment globally and the attendant changing risks there is need to craft, high quality, high performance boards with the appropriate competency mix to steer corporations to success. What is a high quality, high performance board? This is an independent, competent and engaged board, capable of exercising its strategic and monitoring functions.

To achieve this kind of a board it requires a managed and clear nomination process which enables the board to strike the right balance between competency and independence. A look at national codes on corporate governance across the board, suggest that key determinants of an effective board of directors are:

- Existence of non-executive directors, especially independent non-executive directors with no other business ties or otherwise.
- Transparency of the process leading to the nomination and selection of new directors.

- Separation of the role of Chair and CEO
- Board size
- Creation of effective board committees such as Audit, Nomination, Remuneration, etc.

### **Board Composition, Recruitment and Selection of Directors**

In many of our jurisdictions, the major contributor to ineffective and dysfunctional boards is a flawed process of recruiting directors. It is usually premised on the “old school boys” concept, friendships and cross shareholdings etc.

As a result there is a core of a few (roughly about 20 in Zimbabwe) prominent or veteran directors who appear almost on all boards. No consideration is given to develop new directors. Best practice is to employ an explicit competency-based selection process.

Depending on whether it is a board for a private or public corporation a number of factors such as statutory or regulatory requirements, government priorities, gender, geographic representation, germane skills and attributes, will need to be taken into account. The aim is to achieve an optimal board membership mix that not only meets regulatory and governmental expectations but one that makes the board effective and productive. This is a board that achieves both conformance and performance.

The process begins with a review of the vision, mission, values and strategic direction of the corporation to identify

skills and competencies required of directors going forward. The nomination or any other committee tasked with the responsibility, develops a list of competences the board requires, inclusive of areas of expertise, skill sets, perspectives and personal attributes such as integrity, commitment etc. An inventory of current competencies will be taken, and the committee assesses the present composition against competencies and gaps identified.

Subsequently, the full board discusses and approves the competencies and all Board members are encouraged to suggest candidates to fill the vacancies. In the end the committee reviews and vets candidates Vis a Vis the identified competencies and ultimately the committee chooses a slate to submit to the board for approval.

On board composition, the board must ensure that directors focus on such issues as, the manner and practices of the board that provides for the breadth and depth of competencies it needs to support corporate strategy, processes for attracting and selection of new directors, board's own effectiveness in confronting less effective performance among directors, and the team's effectiveness in making the best use of available competencies among the board.

In a similar vein, before the AGM assessments are done of the board as whole and individual directors. The Nomination Committee carries out a similar process to identify and recommend to the board which retiring

directors should be submitted to the AGM for re-election and which ones should not be recommended for re-election.

Best practice is that the re-appointment of directors should not be automatic and must be subject to board and shareowner review and all directors should be for a specific term. Other jurisdictions limit directors' tenure to 3, three year terms. If one is extremely good he/she would have to come back after a year's break. L&G retirements are opportunities to refresh & should be used to the advantage of the company.

The above process should be enshrined in a governance policy which describes how the Board develops competencies and carries out the process of recruitment of directors.

### **Role of Institutional Investors**

Shareholders especially institutional investors need to play a role by taking action against non-performing Directors especially at the AGM. They have a responsibility to make considered use of their vote.

For them to exercise this right and obligation, biographical details, competencies and skills details, number of meetings attended out of the total meetings held by the board/committee and remuneration obtained, on an individual basis by retiring directors seeking re-election must be supplied. Active shareholders should:

- Maintain dialogue on mutual performance objectives and expectations
- Assess & evaluate governance structure & processes in invested companies
- Continuously challenge management to perform and practice good corporate governance

### **Board Balance and Size**

The board should be balanced with the majority of directors being non-executive (NEDs) of whom some preferably the majority, should be **independent**. In terms of size the board should be large enough to include a diversity of the competencies it needs to exercise its responsibilities, but small enough to engage every one in active discussion, make timely decisions, and bond together as a team. Directors need to appreciate that after a given optimal level or size the dynamics change.

### **Competencies and attributes of effective Directors (not exhaustive)**

- Independence: Ability to make objective judgements on issues independently
- Accountability: Willingness to account to shareholders and other stakeholders and uphold ethical standards
- Strategic thinking: Contributing to the strategic process and goal setting. Challenging management assumptions and assuring alignment of company strategy with the business planning processes

- Monitoring: Ability to analyse, assess and review policy objectives, corporate standards and resource priorities
- Decision making: Practicing an ethical decision making processes
- Networking: Building and exploiting networks and promote the organization
- Team work: Being a team player and co-operating with fellow directors and management
- Advising: Making viable suggestions, providing information and recommendations
- Understanding of governance issues: A clear understanding of healthy boundaries among roles of the board, CEO and management.
- Expertise in functional, general management, and inter-relationship issues
- Integrity, honesty, commitment etc.

The point to note is that no one person can have all the competencies needed in the boardroom. A board is a team combining many strengths. In fact the law conceives the board as a collective agency and a collegial body, acting together, taking into account harmful effects of excesses and weaknesses of individuals. Its effectiveness is determined by how the members react, stimulate, hold back, add to or subtract from each other.

### **Role of Non-Executive Directors**

- Role of NEDs: to provide the board with knowledge, objectivity, judgment & balance

- Ensure performance of executives & the corporation
- Constructively challenge the assumptions of management to strategic thinking, for purposes of ensuring sustained corporate viability
- Determine appropriate levels of remuneration of Executive Directors
- Risk: Ensure financial reports are accurate, internal controls and risk management systems are robust
- In other jurisdictions they are expected to meet as a group at least once per year without C/man and Executives and this is to be disclosed.

Effective Non-Executive Directors are expected to play the role of a **watch dog**. However in practice some become **lapdogs** or as others would say watch dogs **without eyes** and bull dogs **without teeth**. To be effective in this role a director need the ability to ask probing questions to find out what he/she does not know, and how to elicit information helpful to the discussion at hand. One needs a quick mind to follow discussions about topics in which one may not have first hand information. Their reputation should be above reproach

Effective directors especially those with a **stake** in the company, have energy investment which goes beyond attending the minimum 75% of meetings, participating in committee work and strategic retreats.

They think about the corporation strategically and globally, they invest

own time in pursuing trends both inside and outside the industry. They quest for more information than that normally supplied by the company, as a way of providing independent input and challenging assumptions.

This kind of director commits himself to what is in the best interest of the company, identifying with all shareholders. High quality, high performance boards do not have factions, each representing a section of constituents, with directors positioned around the table by camps. The effective director is strong and independent and represents all shareholders without personal interest frontiers, committed to change as needed and open to criticism and challenge from his/her colleagues.

### **How can a board be raised up the performance curve?**

Lana J Furr and Richard M Furr speak of 3 levels on the performance curve. Let us see where we would want to take our own board. These levels are Mighty proud to be there, Plateau and High Performance Board.

### **Mighty proud to be there**

This is the stage where being on the board is a status symbol, the stage in which directors occupy chairs ceremonially, enjoying each other's company and in return for their fat board fee cheques, defer to management's thinking and recommendations without questions.

### **Plateau**

With the advent of legislation like Sarbanes-Oxley, following scandals like Enron, boards have been jolted

into the next stage, Plateau. They are aware of the seriousness of expectations from shareholders and other stakeholders like creditors and the legal consequences to directors who fail to exercise due care and skill and loyalty to duty. In these boards meetings now last longer, financials being scrutinized and more and more questions being asked of management before making decisions. Structures like committees are put in place and they push for compliance with the letter of the law.

### **High Performance Boards**

This is the stage where the board aims to perform in addition to conformance. The board follows the spirit of the law, focusing on the intentions of the law as opposed to the letter of the law. At this stage the return on investment of the board is positive and its full potential realised.

The question is how can a board be moved to this coveted stage? Jim Collins in his book "Going from Good to Great" helps us by explaining that companies that achieved this status **first got the right people on the bus, the wrong people off the bus and the right people in the right seats.**

Who are the wrong people in the bus? These are directors traditionally recruited by one individual usually, the CEO or Chair single-handedly, on the basis of kindred spirits, friendships or that one could reciprocate with a seat on their boards and committees. They have developed skills to play the game by avoiding asking questions that create discomfort for the friend/relative

director. Many of these still occupy our boards in many of our jurisdictions.

Who are the right people to get on the bus? It is those possessing competencies that are needed to support the organization achieve its mission, vision and strategy. These are long-term visionary thinkers, also concerned with the short-term goals, international or global markets, understand the nuances of financial reports and other business dynamics.

This process of changing who is on the bus, needs to involve the entire board in a transparent and fair process, which creates a clear picture of the kind of director required in the future. The challenge is whether we are willing and have the courage to do that? In fact observations show that some directors on seeing higher expectations advise of their plans to retire and make way for the new competencies needed.

The process of achieving a high performing board also involves clearly defining the board's role in a more strategic way, Vis a Vis Management. It requires the board to spend more time focusing on the future i.e. looking through the windscreen and not in the rear view mirror.

The board will have to put in place a performance appraisal system for the board itself as a whole and its individual directors and also re-creating its meetings by ensuring that they are productive and efficient.

Instead of spending time listening to management presentations on details included in the board papers, which directors should have read prior to the

meeting, use that time engaging in constructive dialogue shaping a shared picture of how to create a compelling future for the organization.

Change your norms and establish a new culture where directors ask questions in the board room rather than in the parking lot after the meeting. Avoid a situation where directors ask Executive Management challenging questions but not each other.

Do away with a routine agenda and come up with a board work plan that forces you to focus on what each meeting will achieve in pursuing board responsibilities and corporate strategy.

### **Conclusion**

There are issues of corporate governance that are peculiar to the insurance industry and these require careful attention of Directors and informed decisions. We also need to develop effective high quality high performance boards. In conclusion we may have excellent national and individual codes of corporate governance, and grandiose corporate governance statements in our reports.

These will not create high quality, high performance boards. Effective boards depend on the best people and on their behaviors and relationships. It is the way that people work that will create a great board. Competencies are first and last, they are paramount in creating great boards, more so now when the pool of capable and willing directors is shrinking because of increasing responsibilities and potential liabilities. Benefits of clear and transparent board recruitment processes, good board composition mix and competencies are worthy pursuing. The success or failure of corporations rests in the stewardship of Directors.

In respect of the future of our corporations and indeed Zimbabwe, Richard R Neville says “We honour the past, we live in the present, but now must engage the future. If we do not engage the future, but simply acquiesce we become the victims of someone else’s agenda. ■

**The future is not a place where we are going, but a place we are creating.**