Boards of Insurance Companies

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The board of an insurance company is the supreme governing body of the company. It has numerous stakeholders and many duties, which are discussed in this paper. The literature review concerns e.g., non-executive directors, board risk taking and oversight, ESG and diversity policies. In the discussion the relation of the board to the stakeholders and the duties and obligations of the board are described. The stakeholders include owners of the company, the CEO of the company, FSA and outsourcing partners. Other covered topics include key functions of the company, closing of the books, investments, solvency, compliance, recruitments, remuneration, product development, board committees and board training.

Keywords: insurance company, insurance company government, insurance company board

INTRODUCTION

The board of an insurance company is the supreme governing body of the company. It has numerous stakeholders and many duties, which are discussed in this paper. Most of these duties are imposed by the regulation. After a literature review the relation of the board to the stakeholders and the duties and obligations of the board are described. In the conclusion the legal position of a board, recruitment of board members and competence requirements of a board member are discussed.

LITERATURE REVIEW

Non-Executive Directors

Much has been written about non-executive board members, i.e., persons who do not work for the company.

The study by O'Sullivan and Diacon (2003) seeks to add to our understanding of the governance role of non-executive directors by examining the use and usefulness of non-executives in insurance companies. Their results suggest that mutual insurers utilize a greater proportion of non-executive directors and are less likely to have CEO/Chairman duality than their proprietary counterparts. This evidence is consistent with mutuals using stronger board governance to compensate for weaker ownership control. Proprietary companies, which are subject to stronger shareholder and capital market control, place less reliance on non-executive monitoring. Overall, their findings suggest that insurance companies emphasize different governance mechanisms depending on the specific monitoring problems they face.

He et al. (2012) find that the Sarbanes-Oxley Act of 2002 (SOX) has a significant impact on both public and private insurance firms, albeit in different ways. After SOX, they observe increased board independence and decreased incidences of combining the positions of the CEO and the Chairman of the Board for public insurers. Although SOX has no discernible impact on the overall trends of board structure of private insurers, He et al. find that larger and less-levered private insurers experience increased board independence post-SOX.

Mayers and Smith (2010) state that monitoring by outside board members and incentive compensation provisions in executive pay packages are alternative mechanisms for controlling incentive problems between owners and managers. The control hypothesis suggests that if incentive conflicts vary materially, those firms with more outside directors also should implement a higher degree of pay-for-performance sensitivity. The authors' evidence is consistent with this control hypothesis. They document a relation between board structure and the extent to which executive compensation is tied to performance in mutuals: compensation changes are significantly more sensitive to changes in return on assets when the fraction of outsiders on the board is high.

He and Sommer (2010) investigate the implications of separation of ownership and control for board composition over a spectrum of ownership structures present in the US property-liability insurance industry. They show that agency costs associated with manager-owner conflicts increase with the degree of separation of ownership and control. Use of outside directors is expected to increase as the separation of ownership and control gets larger.

Biase and Onorato (2020) list the duties of the board of an insurance company in a very compact way: Although there is no universal governance model, it is possible to set sound principles to make management activities and processes transparent and effective in the interest of stakeholders. In this context, the company board and its composition play a key role. The insurance companies' board evaluates the insurer's maximum acceptable risk, while monitoring minimum capital requirements according to the actual risk assumed, approves risk management policies, is responsible for audit activities and defines adequate requirements for board members and top management. In addition, the board must clearly define the governance system, while monitoring internal organisational structure to ensure efficiency, effectiveness and transparency.

The research by Biase and Onorato aims to investigate the relationship between a wide range of board characteristics and corporate performance in the insurance sector. Their findings provide evidence that board structure and board independence are the most relevant governance factors, with a potentially positive impact on insurers' market performance. These findings indirectly outline the opportunity for insurance companies to improve corporate fair value by strengthening internal governance models through effective board policies, an adequate qualification of board members and a well-balanced membership of the board that means a solid financial expertise of board members and a satisfactory level of gender and cultural diversity within the board. At the same time, there is still room for improvement as regards the level of board independence by strengthening internal governance policies in order to maintain an adequate number of independent and non-executive board members.

Adams and Jiang (2017) examine the relation between board-level financial expertise and six measures of performance using panel data drawn from the United Kingdom's non-life insurance industry. Collectively, financial experts have a beneficial influence on the performance outcomes of insurers. The authors also observe that board-level qualified accountants and actuaries are linked with superior performance in all six of the selected financial outcome measures. Underwriters may not be as adept at group-level earnings enhancement as accountants and actuaries. In addition, the authors find that the introduction of IFRS 4 in 2004/2005 did not have a significant impact on board composition and financial outcomes.

The paper by Hardwick et al. (2011) examines the effects of corporate governance mechanisms (measured by a set of board characteristics) on the profit efficiency of United Kingdom (UK) life insurance firms. They find that, viewed in isolation, board characteristics tend to have little effect on firm efficiency in the UK life insurance market. However, they do find that the proportion of non-executive directors on the board exhibits a significant effect on the profit efficiency of their sample UK insurers once the interaction effects among governance mechanisms are taken into account. The effect can be either positive or negative depending on whether there is separation of the CEO and board chairman positions and whether there is an audit committee. These results suggest that corporate governance is an inherently complex process.

Board Risk Taking and Oversight

The study by Dupire et al. (2022) investigates the relationship between board risk oversight practices at financial institutions in the EU and systemic risk during the sovereign debt crisis. They construct a risk oversight index based on publicly available, hand-collected data, which captures the strength of the institutions' board-level risk governance practices. The authors find that financial institutions with stronger board risk oversight prior to the crisis were less vulnerable to the sovereign debt crisis, after controlling for other factors.

The study by Elamer et al. (2018) aims to examine the impact of internal corporate governance mechanisms on insurance companies' risk-taking in the UK context. The results show that the board size and board meetings are significantly and negatively related to risk-taking. In contrast, the results show that board independence and audit committee size are statistically insignificant but negatively related to risk-taking. The findings are robust to alternative measures and endogeneities.

The study by Ho et al. (2013) examines the impact of organizational structure and board composition on risk taking in the U.S. property casualty insurance industry. The evidence shows that mutual insurers have lower total risk, underwriting risk, and investment risk than stock insurers. The authors find that some board composition variables not only have impact on risk-taking behaviours but also affect different risk measures differently. Thus, using different risk measures is better than using one risk measure to assess risk-taking behaviour.

The aim of the paper by Alfiero and Venuti (2016) is to develop empirical research on the nature and consequences of corporate governance on Eurozone Insurance Industry risk taking attitude. More particularly, they analysed the effect of public ownership on risk taking with respect to privately held Insurance Companies. They also analysed the effects on risk taking attitude of different degrees of ownership concentration, directors' compensation, and the dimension/diversity of the Board of Directors. The authors' results provide quite strong evidence that, coherently with the Agency Theory, publicly traded insurance companies with more concentrated ownership are less risky than the corresponding privately held.

ESG

ESG **(**Environmental, Social, and Governance**)** principles have been increasingly taken into account by all companies including insurance companies**.** Jergler (2021) reports: A report out Thursday from a climate change advocacy group alleges that more than one-fifth of U.S. insurance company board members have worked for the fossil fuel industry, and that two-thirds of all U.S. insurance company board members are "climate conflicted." The research was conducted by a network of investigative reporters focused on climate journalism. They looked at 371 directors in 30 of the world's top property and casualty insurers. Jergler points out: "The directors of these insurers have the chance to put themselves on the right side of history." In Europe, 11% of directors have worked in fossil fuels, and 57% are "climate conflicted."

Ullah et al. (2019) examine empirically the association between corporate governance and the extent of corporate social responsibility (CSR) disclosures in insurance companies, using archival data. The authors find that board independence and the proportion of female directors have positive associations with the extent of CSR disclosures. However, the results indicate that managerial ownership is negatively associated with the extent of CSR disclosures.

Diversity Policies

The paper by Pernsteiner and Wagner (2017) focuses on supervisory boards and investigates various board characteristics for the largest German and Austrian insurance companies. Furthermore, the study examines the link between diversity policies and financial performance. The study reveals some differences between the two aforementioned countries, which are mainly driven by size effects. In addition, the analysis shows that larger and stock listed insurance companies have better diversity management policies and a higher proportion of female directors. There is no significant correlation between gender diversity measures and profitability.

Birindelli and Iannuzzi (2022). provide an overview of the gender diversity policies adopted by banks and insurance companies worldwide over the last 11 years (2010–2020). The data considered are e.g., the percentage of female directors on the board and the board gender diversity policy. Overall, the analysis shows that women are still underrepresented in managerial and especially executive roles in both the banking and insurance sectors. On the other hand, the number of women directors, managers, and executives has increased, although at very different growth rates. In any case, this rebalancing process is still ongoing and will be so for a long time.

Other Research

CEO duality (The chairperson of the board and the CEO are the same person) has been a widely studied governance issue in the past decades. Some of this research is included in the previous chapter "non-executive directors" Another example is Miller and Yang (2015). They find strong evidence that CEO duality is a complex decision that insurance firms fine-tune in response to their individual circumstances. Compared to other industries, the insurance industry is unique in that the costs and benefits of CEO duality vary more with firm size. Miller and Yang find no evidence that CEO duality is detrimental to firm performance. If anything, the valuation impact of CEO duality appears to be positive for large insurers. Evidence suggests that regulatory initiatives targeting CEO duality of insurance firms should pay close attention to the role of firm size.

Rink et al. (2022) study the reflexivity of Top Management Teams (TMTs) and TMT-board conflicts. They examine how the TMT-board interface internal to the organization, as well as the TMT interface with the external supervisory authority, shape TMT reflexivity. The findings demonstrate that the link between cognitive and affective TMT-board conflict is mitigated by board membership influx. Yet in cases where conflict escalation does occur, its subsequent impact on TMT reflexivity hinges on the degree to which an external supervisory authority monitored TMT actions.

Corvese (2017) investigates the consequences on the duties and responsibilities of the board of directors of insurance companies after the implementation of the ORSA system in the Canadian and Italian legal systems, considering in particular the guidance provided by the respective authorities for the insurance sector in these countries. With reference to the effects of ORSA's implementation on corporate governance in insurance companies, in the author's opinion, it is possible to reach the same conclusions about Canadian and Italian regulations.

Talonen et al. (2018) explore the mental models of customer ownership held by executive-board-level managers. Customer ownership can have a limited, applied, strategic, or extensive function in the mental models of the executives.

Governance and the internal control system represent a fundamental pillar in the Solvency II Directive. In that context, the insurance companies' board plays a key role in assuming new responsibilities and duties. Dell'Atti et al. (2018) examine the role of insurance companies' boards in view of the important changes introduced by Solvency II. An empirical analysis is conducted on a sample of 102 Italian insurance companies. Three areas of investigation, size and composition, board self-assessment processes and board remuneration policies, are covered by the survey. The results show a satisfactory level of compliance of the boards with respect to the requirements established by Solvency II. There is still room for improvement as regards the level of disclosure and diversity. The paper contributes to deepen the understanding of Solvency II effects on the composition and functioning of insurance companies' boards.

DISCUSSION

The board is the supreme governing body of an insurance company. Its numerous stakeholders and many obligations are discussed in the following.

Owners

A board can consist of representatives of owners and independent members (insurance experts). Often a board is a combination of these member types. It is important to note that board members must always hold the company interest first and not try to achieve benefits to the interest group he/she represents. The board has to communicate with the owners sufficiently often. If they are not happy with the board or some of its members, they can any time hold an extraordinary shareholder meeting and change the board.

CEO

The most central duty of a board is to hire and fire the chief executive officer. The role of the CEO is fundamental for the board. It is the duty of the CEO to prepare and introduce the items in board meetings. The closest collaborator of the CEO is the chairperson of the board, and it is conventional that the CEO introduces the preliminary board meeting agenda with draft presentations to the chairperson before each meeting. The CEO can request from the chairperson authorisation to actions which do not require the decision of the whole board. The CEO is the window of the board to the company staff because in most cases board members do not meet other staff members so often. The board as a whole is the superior to the CEO, so if some board member wishes something to be accomplished, it is the obligation of the CEO to carry out the request if it is not impractical.

Key Functions

Following the Solvency II Directive, the four key functions of an insurance company are

- The actuarial function
- The risk management function
- The compliance function
- The internal auditor.

These key functions have to report about their recent progress to the board quarterly, and even more often, if necessary. Key function holders can be external persons. The actuarial function and the risk management function have much in common, e.g., the estimation of the solvency capital requirement, and it is essential that they have good cooperation. Own Risk and Solvency Assessment (ORSA) is one of the most fundamental annual duties for the board, and the risk management responsible or CRO assists the board in completing ORSA.

FSA

Insurance is heavily regulated. The insurance companies have to track constantly legislation and its changes, rules and instructions given by the Financial Supervisory Authority (FSA). The role of FSA is highlighted already in the licence application phase, because FSA is the official which grants the licence (at least in Finland). If a company turns insolvent and the status is not remedied or something else inappropriate happens in the company, the FSA has the power to revoke the licence.

The FSA requires cyclic reports especially about actuarial and solvency matters. The board has to watch that the key functions deliver their reports in time and error-free. Failure to do so may cause punishment. The FSA wants to watch quite closely the supervised companies by regular meetings. The FSA requires that a company has a real-time governance system, which is also the company board's responsibility.

Outsourced Functions

Most companies outsource at least some of their functions. If a key operation is outsourced, the FSA wants to see quite comprehensive documentation on the outsourcing. Also, some other outsourcings like ICT and investments require exact agreements. The execution of outsourced functions has to be observed regularly. The staff member responsible for the monitoring must tell his/her findings to the board at least quarterly. The board must oversee that the important outsourcing documents are suitable.

Closing of the Books

The board proposes a name of an external auditor for the annual general meeting. An important occasion for the board is the annual meeting where the company books are closed and the auditor gives to the owners his/her report on the accounting year and his/her recommendation of the freedom of responsibility for the board and the CEO.

Investments

For investment management of an insurance company, see Voutilainen (2022a). Even if there is an investment working group in most companies, the most essential investment decisions are done in the board. These include nomination of asset managers, change in the investment plan, changes in wealth allocation, changes in wealth class limits etc. The investment performance of the total assets shall be reported cyclically, and more often when there is crisis in the investment market.

Solvency

For solvency management of an insurance company, see Voutilainen (2022b). Solvency is a pivotal factor in the existence of an insurance company, so it is evident that the board has to monitor solvency strictly and regularly. They are contributed by the actuarial and risk management functions which give the latest figures of Solvency Capital Requirement (SCR), Minimum Capital Requirement (MCR) and the Solvency Ratio (SCR/Own funds). In the government system of the company there shall be instructions what the board shall do in any solvency ratio zone. For example, when the ratio decreases, risk has to be cut e.g., by investment changes or reinsurance, and when the ratio increases, extra profit division has to be considered. If the solvency deteriorates and the board cannot correct the situation, a quick intervention by the FSA is probable.

Compliance Issues

The regulation and the FSA require that each company is compliant with such topics as Anti Money Laundering (AML), Financial Crime (FC) and data security. The company must also have The Business Continuity Plan. The company must appoint a compliance officer (internal or external) who reports to the board the progress of compliance issues.

Major Procurements

The biggest acquisitions of a company have to be presented for the board to decide. The government system of the company must tell how big acquisitions can be made by the CEO (or his/her subordinates) and which must be presented to the board. Such big acquisitions or procurements are e.g., ICT systems and reinsurance.

Recruitments

As stated before, the board is responsible for the appointment of the CEO. It is conventional and good governance that the CEO brings the appointments of senior officers to the board with remuneration details.

Remuneration

Oversight of the remuneration structure of the company is a duty of the board and the CEO, perhaps the chairperson of the board above others. The board decides the salary revision and the possible variable salary parts for the CEO, and makes the decisions about the rest of the staff according to the CEO's suggestions. It is an important task for the board to ensure that the remuneration level for each staff category is competitive with the normal level within the industry. Salaries shall also be fair compared to each other. The CEO can assist the board with this oversight.

Product Development

The board has to be closely involved in product development projects. The CEO shall report the developments of projects in board meetings. The board has to think about the presented business cases and the solvency effects of a possible launch of a new product. Here the actuarial function and the risk management function can assist the board. The board has to make sure that there is adequate market for the new product and that the product complements the existing product portfolio. If the new product becomes a failure, the board is inevitably responsible.

Committees

It is common that small boards (and small companies) function without committees. However, most boards elect among board members an Investment Committee and an Audit Committee. The Investment Committee helps the board in their decisions, see Chapter "Investments" above. The Audit Committee assists the board by becoming acquainted with the presentations of key functions before they go to the board. Big insurance companies and especially listed companies have often nomination committees representing biggest owners for selecting new board member candidates for an annual general meeting.

Training

The regulation and the FSA require that the company board members are suitable, i.e., fit and proper for their duties in the board. This is required already when the members enter the board, but the fit and proper requirement is in force for the whole board membership period. This implies that the board members must be given appropriate training on new legislation and everything they handle as board members. The training can be given by company staff or external service providers.

CONCLUDING REMARKS

In the previous chapters we have discussed duties of an insurance company board. The board has a big responsibility towards the owners, and every now and then there appear lawsuits against boards for failing to manage the company appropriately. Therefore, it is customary to have directors' and officers' liability insurance for those kinds of demands.

It is sometimes a challenge to find board members who as a whole represent the owners and have excellent expertise on insurance matters. Individuals from competing companies are naturally excluded. Especially in the beginning it is often practical to use consultants in insurance technical and legal matters.

The career as a board member is challenging: The relation with the CEO has to be close but not too close, the same holds for the other staff members. You have to learn a lot about regulation, solvency, investments, actuarial matters, financials, compliance etc. It is a duty of the chairperson and the CEO to ensure that the board gets sufficient information about what is happening.

ENDNOTE

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