Oct 26th, 11:00 AM - 12:30 PM

Corporate Governance in Insurance Companies – Need or Trend?

Vesna Paunkoska Dodevska
Triglav Insurance Company JSC, vesna.paunkoska@triglav.mk

Bashkim Nuredini
University for Business and Technology, bashkim.nuredini@ubt-uni.net

Corporate Governance in Insurance Companies – need or trend?

Vesna Paunkoska Dodevska, Bashkim Nuredini

[1]Triglav Insurance Company JSC, 1000 Skopje, Republic of North Macedonia
[2]UBT – Higher Education Institution, Lagjja Kalabria, 10000 p.n.,
Pristina, Kosovo

Abstract. In recent decades corporate governance is very actual topic, especially in financial institutions, and more and more investors and regulators in the insurance industry have insisted on establishing an adequate corporate governance system. But what exactly is corporate governance? Is it just a trend or a real need for the insurance companies?
Good corporate governance is undoubtedly necessary to maintain a fair, safe and stable insurance sector that will protect the interests of insurers, which in return will contribute to the stability of the financial system as a whole. The insurance industry, like other parts of the financial system, is undergoing a number of changes and that is why insurance companies need to have a stable corporate system in order to face changes easily and respond adequately to rapid sociological, technological changes and economic development.
The benefits of good corporate governance are unquestionable - they provide for greater competitiveness of insurance companies, increased efficiency and corporate results, greater company asset value and higher company reputation, all of which are important factors in the modern business environment.
Finally, it should be noted that corporate governance is not a once-established system, but a continuous process that needs to be constantly upgraded and improved. The market is the one that will evaluate and value the commitment of the insurance companies in the process of building an adequate system of good corporate governance in the long run.

Key words: Insurance, Corporate Governance, Investors, Company Reputation, Business environment

A word or two about corporate governance

In recent decades, corporate governance has been an actual topic, especially in financial institutions, and more and more investors and regulators in the insurance industry have insisted on establishing an adequate corporate governance system. But what exactly is corporate governance? The traditional definition of corporate governance refers to the relationships between management (top management), the board of directors, or the supervisory body, company shareholders, and other stakeholders, such as employees and their representatives. Corporate governance defines the structure through which the goals of the company are defined, as well as the means to achieve the goals and oversee the results achieved. [1]
As the term itself suggests, corporate governance is a system through which the insurance company is internally regulated. It is a complex system that incorporates many aspects of the business of an insurance company, such as:

- corporate culture and environment (values, ethics, establishment of a system for reporting employees' non-compliant behavior, etc.);

- corporate structure (board of directors, ie management and supervisory board, top management, company executives, business functions, etc.);
- basic documents and policies (internal acts, organizational structure rules, rules of procedure for the organs of the company, etc.);
- strategy, policies, procedures and controls (risk management, compliance with positive regulations, internal and external audit, financial reporting, etc.) and
- making decisions and taking actions related to the corporate culture, environment and structural framework, policies and controls.

In the broadest sense, corporate governance defines roles, obligations and responsibilities. It actually clarifies who is responsible and who has the legal power to act on behalf of the insurance company and under what circumstances. Corporate governance involves making decisions and taking actions in accordance with corporate logic, as well as an obligation to disclose them to stakeholders. A well-established corporate governance system gives insurance companies the opportunity to take corrective action in case of non-compliance with positive regulations or poor oversight, control and management. Hence, it can be concluded that corporate governance is the allocation and regulation of power and responsibilities in insurance companies, thus avoiding unnecessary concentration of power. Therefore, corporate governance is often referred to as a "check and balance" system, reflecting the fact that insurance companies need to be flexible in order to make timely decisions, while at the same time insurance companies need to be transparent and have adequate controls in place, systems and controls to guide management in the best interests of policyholders, shareholders and the company as a whole.

Corporate Governance in the European Union

European corporate governance history

European Union is developing a system in which effective and accountable companies report to responsible shareholders. This process generally started in 2000 and it is still ongoing. According to some authors and analysis, the process has been slow and predictable, taking into account the different corporate governance systems in all EU member states, their legal and political backgrounds, the divers' philosophical approaches to governance, the various ownership structure in the member states. [2]

Instead of adopting single rules for all EU member states regarding the corporate governance, European Union has established a principles- based comply-or-explain regime for member state–based corporate governance codes. But, despite of that fact, at EU level policy initiatives are ongoing, trying to improve the corporate governance along with the goal of promoting the larger macro goals of enhancing economic growth, reducing market inefficiencies, and particularly since the financial crisis, avoiding undue risk to the financial system and to European economies more generally. The different initiatives for regulating the corporate governance in European Union are focused on boardroom diversity, minority shareholders rights, increasing information flows, encouraging institutional investments, risk management etc. [3]

The expected and reasonably transparent approach to the European corporate governance policy process since 2000 arises from what tends to be a slow and thoughtful approach to policymaking. Usually, the process starts with the commissioning of studies; these studies then become consultative “Green Papers,” which then are turned into “Action Plans,” and then into specific Laws, Directives, or Recommendations in a process that can span several years. [4] The financial crisis had a deep impact in Europe on financial markets and economies, and the effects are still present in some pores of society. Practically, the crisis led to a further review of fundamental principles and assumptions about corporate governance, including the premise of investor primacy.

In this context, the European Parliament established a corporate governance debate, raising broad issues of how corporate governance should reflect a company's social performance and its impact on employees, stakeholders, and civil society in general. This perspective can still be found in the European Parliament through its advocacy of enhanced employee rights and gender diversity as well as through building greater awareness of social, ethical, and environmental issues affecting companies.

In May 2017 European Parliament and European Council have adopted Directive (EU) 2017/828 amending the Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement. This Directive establishes requirements in relation to the exercise of certain shareholder rights attached to voting shares in relation to general meetings of companies which have their registered office in a Member State and the shares of which are admitted to trading on a regulated market situated or operating within a Member State. It also establishes specific requirements in order to encourage shareholder engagement, in particular in the long term. Those specific requirements apply in relation to identification of shareholders, transmission of information, facilitation of exercise of shareholders rights, transparency of institutional investors, asset managers and proxy advisors, remuneration of directors and related party transactions. The main reasons for adoption of this Directive is that financial crisis has revealed that shareholders in many cases supported managers' excessive short-term risk taking. Moreover, there is clear evidence that the current level of 'monitoring' of investee companies and engagement by institutional investors and asset managers is often inadequate and focuses too much on short-term returns, which may lead to suboptimal corporate governance and performance.

Separate of the formal public policy process, unformal policies are focused on investor, company, and regulatory communities about the role of culture, behaviour, and ethics in terms of shaping responsible corporate governance and investment practices. This focus recommends less reliance on traditional features of corporate governance codes or public policies and raises questions about the extent to which policy initiatives can meaningfully address qualitative or behavioural issues, such as corporate culture and conduct risk, and the degree to which regulators can have confidence in the integrity of the system and be encouraged not to overregulate. [5]

Corporate governance issues in the insurance sector

The insurance sector as integral part of the financial industry is pretty much regulated and in the same time supervised sector. On the European Union level Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) was adopted. Although the main focus on this Directive are the capital requirements, governance issues are also essential part of it.

The 2008 financial crisis showed that financial institutions' corporate governance was unsuccessful mainly because of the excessive risk-taking, boosted by generous executive remuneration. In this scenario, the insurance industry has been less affected by the financial crisis in comparison to the banking system, although it was still partially involved in the derivatives turbulence. Along this decade various reforms relating to banks, insurance and investment firms have been enacted in response to the financial crisis. [6] The attention of the reforms in the European Union has been paid to the structure and functioning of the board, the risk management policy and internal control system, and the executive remuneration and supervision. [7] Still, at the core of the European reforms stands the idea of strengthening the role of the board to avoid excessive and imprudent risk-taking. In fact, the main goal of the

Solvency II directive is to ensure an adequate protection of policyholders and beneficiaries, also through a new risk management, financial reporting and corporate governance assessment. [8]
From insurance sector point of view European legislation after the financial crisis clearly shows that the regulation of corporate governance goes beyond the traditional approach of company law, because the governance regime should ensure not only the "integrity of the market" to reduce the excessive risk-taking, but also the "investor protection" as far as the MiFID regime [9] is concerned and "policyholder protection" as far as insurance is regulated under the Solvency II regime. The focus on trust is even more apparent in insurance legislation. In fact, the main goal of the Solvency II directive is to ensure an adequate protection of policyholders and beneficiaries, also through a new risk management, financial reporting and corporate governance assessment. [10]

Corporate governance system in Solvency II Directive

As was already mentioned above, Solvency II Directive is a complex set of rules that aims to ensure adequate protection of policyholders. [11] One of that set of complex rules is focused on improving the corporate governance system in the insurance companies. The Solvency II Directive contains the most important topics to be regulated to ensure appropriate governance standards within insurance companies.
More preciously, the Solvency II Directive regarding the system of governance regulates the following issues: general governance requirements, fit and proper requirements, risk management, internal control and outsourcing. The "general governance requirements" aims at the implementation of an effective and proportionate system of governance, which provides for sound and prudent management of the business and sets out the implementation of written policies concerning the main functions of the undertaking (i.e. risk management, internal audit, internal control, outsourcing).
The mentioned governance requirements are further elaborated in the EIOPA Guidelines on the System of Governance and together with the Solvency II Directive they are addressed to the competent national authorities that should implement the provisions in the practice through appropriate measures. [12]
The Solvency II Directive requires all insurance and reinsurance undertakings to have in place an effective system of governance which provides for a sound and prudent management of the business. That system shall at least include an adequate transparent organizational structure with a clear allocation and appropriate segregation of responsibilities, as well as an effective system for ensuring the transmission of information. In line with corporate governance best practices, the EIOPA Guidelines put particular emphasis on the company's organization referring, as usual, to four main areas: an effective system of governance (comprising risk), the internal control system, the organizational and operational structure and the decision- making process. [13]
One of the principles defined in the EIOPA Guideline is the duty of the administrative, management or supervisory body to be informed. The nature and structure of the administrative, management or supervisory body varies with the national company law applicable in the jurisdiction in which the insurance company is incorporated. The term "administrative, management or supervisory body" covers the single board in a one-tier system and the management or the supervisory board of a two-tier board system. According to the Solvency II Directive, the responsibilities and duties of the different bodies should be seen having regard to different national laws.
"Duty to be informed" principle means that the board has to interact "proactively requesting information from them and challenging that information, when necessary" with committees (if established), senior management and key functions. This means that directors have to behave proactively, not only to carry out the strict duty of monitoring. Indeed, directors not only have to check the information provided, but should also collect sensible information on their own. This solution could affect the general principle that directors can rely on officers' information.

In this case, the liability area of non-executive directors would increase dramatically. But, on the other hand the Solvency II Directive does not make any explicit reference to a proactive behaviour, but it rather refers to, among others things, an effective system of governance and requires to set up an appropriate segregation of responsibilities. That's why some authors consider that it is questionable whether a too wide monitoring duty fits with effectiveness, and whether it allows to easily separate executive and non-executive tasks.

The second guideline from EIOPA Guideline refers to organizational and operational structure and its meaning in every insurance company. Both are necessary to ensure a proper flow of information among the company's different levels of hierarchy. In this regard, the organization structure determines the tasks and assignments, while the operational structure settles the way of performing the tasks. In recent times, organisational and operational structure are based on a cost and benefit approach. This is a fundamental change to the Solvency I directive, that was based on the 'one size fits all' principle. This new approach, on the one side, introduces more flexibility in corporate governance system of each company and, on the other side, increases the responsibility of the board, if compared to the previous regulatory framework.

Other principle set up in EIOPA Guidelines is the obligation to the company to review the system of corporate governance internally and periodically. The company have to determine the appropriate frequency of the reviews taking into account the nature, scale and complexity of their business and assign responsibility for the review to be documented as appropriate. Suitable feedback loops should exist to ensure follow-up actions are continuously undertaken and recorded. In order to allow an adequate revision of the system of governance, appropriate reporting procedures encompassing at least all key functions should be established. The responsibility for realization of this principle is on the administrative, management or supervisory body of the insurance company. In relation to key functions, EIOPA does not requires mandatory organisational structure of separate units focusing on risk management, compliance, internal audit and actuarial function.

The EIOPA Guidelines include some more specific requirements with reference to the four-eyes principle. As for the decision-making process, the four-eyes principle foresees that every significant decision is effectively taken by at least two persons "before the decision is being implemented" (Guideline 3). Significant decisions are decisions that are unusual or that could have a material impact on the undertaking (Guideline 3).The Guideline does not specify whether these two persons must necessarily be directors or not. Arguably, the second option is the most suitable, because the provision refers generally to "persons". Several situations could arise in practice, considering, for example, the case of two executive directors or (only) one executive director. In the first hypothesis, if the two executives are in charge of the business and takethe decision jointly, there seems to be compliance with the Guidelines. By contrast, the case in which a delegation of different exclusive tasks is given to each director appears to be more problematic. Overall, it seems that in both cases, the question is whether the "two people rule" is aimed to ensure either a better level of competence or a better monitoring function. Considering that quite rarely an undertaking appoints two executives for the same area of competence and that the regulator is well aware thereof, it can be assumed that the goal of this principle is to ensure a better monitoring function.

Corporate Governance Structure of Insurance Companies in the Republic of North Macedonia

The basic legal foundations of corporate governance of insurance companies in the Republic of North Macedonia are set out in the Law on Trade Companies, the provisions of which define the frameworks within joint stock companies should regulate their corporate governance. The Law on Insurance Supervision through its provisions, as a lex specialis for insurance

companies, sets higher standards for the corporate framework which is quite logical considering the specifics of the insurance industry - covering economic, financial, corporate and other risks for companies, such as and covering different spectrum of risks for households and individuals.
The highest body of insurance companies is the Shareholders Assembly. Shareholders exercise their rights at the Shareholders Assembly. Every shareholder has the right to participate in the Assembly and the right to vote from the moment of registration in the share book. The Assembly is the only forum where shareholders exercise their rights in insurance companies. The Assembly cannot decide on issues in the area of management, or in the area of managing the operations of the insurance companies that are within the competence of the management body. Only by way of exception can certain shareholder rights be granted to the Shareholders Assembly in the part of approving a deal with an interested party and a large deal.
Regarding the management structure of both regulations, the insurance company has the opportunity to choose between different management systems: the two-tier system, where the management and supervisory roles are played by two different boards - the management and supervisory board and the one-tier system, where the management and supervisory functions perform various members (executive and non- executive) within the same body - the board of directors. However, the ultimate goal of both systems is the same, no matter which system the insurance company chooses - to provide complete oversight of the operation and implementation of the company's strategy, as well as the proper management and execution of the decisions made. In doing so, both relevant laws clearly define the role and responsibilities of the supervisory and management body, precisely defining the conditions and qualifications that a person must possess in order to be a member of the management or supervisory board, which are his or her rights, obligations and responsibilities. Well-defined frameworks for members of the management and supervisory bodies are particularly important because in the insurance industry, members need to be able to understand the complex issues related to insurance business, actuarial, accounting, law, information technologies and claims collection. The insurance market imposes the need for the managing and supervisory body to be composed of members with integrity, relevant knowledge and experience. The quality of the individuals and their behavior, as well as the structure of all members of the managing and supervisory body, are as important to good corporate governance as the existence of appropriate structure and practices in the insurance company. Regarding the members of the companies' associates, another important characteristic that has been established in accordance with the relevant legal norms is their independence. Both laws set the minimum required for independent members and define the independence of members of the bodies. Insurance companies may also prescribe higher criteria for the independence of members from that established by the law, and in accordance with good corporate governance practices, it is expected that members of the company's bodies act objectively, independently to make conclusions and decisions in accordance with the interests of the insurance company. If there is a conflict of interest with the members of the management and supervisory body, and in such situations the members should act in accordance with the internal rules of conflict of interest.
The corporate legal framework of the Republic of North Macedonia provides an opportunity for the Board of Directors, or the Supervisory Board of the insurance companies, to form committees as their subsidiary bodies. This allows formation of smaller groups that will focus on and specialize in the specific area and thus help to increase the effectiveness of the boards. The most commonly established committee in insurance companies is the audit committee that provides oversight and control over financial reporting, internal controls, the effectiveness of internal audit, and recommendations in selecting an audit firm. Other committees that insurance companies may form are: nomination and selection committee, remuneration/remuneration committee, ethics committee, risk management committee, investment committee, data disclosure committee, corporate governance committee, human resources committee, strategic development committee, real estate management committee and a number of other committees.

An important role in the overall structure of corporate governance is played by both the management and the internal legal adviser (secretary of the insurance company). The role of the internal legal advisor is to ensure proper implementation of the regulations by the management and supervisory body, assist the chairman of the Board of Directors or the Managing or Supervisory body in organizing meetings and is responsible for relations with shareholders. Managers participate in the day-to-day running of the insurance company in accordance with the strategy of the company and the decisions made by management and supervisors. These persons are usually placed in a precisely defined area of business of the insurance company and need to have the appropriate knowledge, experience and skills to perform the assigned tasks and responsibilities. Specific to the corporate structure of insurance companies, unlike other companies, is the obligation to introduce control functions that undoubtedly enhance corporate governance. First of all, the Law on Insurance Supervision has more closely defined these functions, with a view to the stable and safe operation of the insurance company and the insurance sector in general. It is very important for insurance companies to properly understand the risks involved in their operations and the liabilities they incur. It involves a sound knowledge of the sources of risks, the types of risks, the characteristics, the internal relationships and the potential impact of the business, as well as the laws and regulations applicable to the insurance company and the employees involved in the risks. That is why it is important for insurance companies to have: [14]

- good and efficient mechanisms for identifying, evaluating, quantifying, risk control, mitigation and monitoring;
- appropriate strategies, policies and procedures to ensure compliance with internal strategies and policies, and applicable laws and regulations;
- adequate internal controls to ensure that risk management functions and compliance with regulations are complied with, and
- the internal audit function be able to audit and evaluate the adequacy and effectiveness of compliance with regulations, internal controls, and policies and procedures.

Controlling functions in insurance companies should be performed by persons with appropriate integrity, competences, experience and qualifications. These individuals should be able to demonstrate an appropriate level of knowledge and expertise in these areas and to meet professional standards. The independence of the holders of control functions is also a key issue and insurance companies can provide this in a variety of ways, such as direct reporting to the supervisory authorities by the holders of control functions and similar. According to the legislation of Republic of North Macedonia, as well as the practice of good corporate governance in insurance companies, the following are the control functions: internal audit function, actuarial function, risk management function and regulatory compliance function.

Conclusion

Good corporate governance is undoubtedly necessary to maintain a fair, safe and stable insurance sector that will take care of the good and protect the interests of insurers, which in turn will contribute to the stability of the financial system as a whole. The insurance industry, like other parts of the financial system, is undergoing a number of changes and that is why the insurance companies need to have a stable corporate system in order to face the changes more easily and to respond adequately to the rapid sociological, technological and economic development.

The benefits of good corporate governance are unquestionable - they provide for greater competitiveness of insurance companies, increased efficiency and corporate results, greater value for company assets and higher company reputation, all of which are important factors in a modern business environment.

Finally, it should be noted that corporate governance is not a once- established system, but a continuous process that needs to be continually upgraded and upgraded. The market is the one that will evaluate and value the commitment of the insurance companies in the process of building an adequate system of good corporate governance in the long run.

References

1. OECD Homepage, https://www.oecd.org/corporate/principles-corporate- governance.htm
2. G. Dallas & D. Pitt – Watson, “Corporate governance policy in the European Union”, pages 7 -13, CFA Institute, August 2016
3. V. Ribas-Ferrer, "Corporate governance in European Listed Comapnies and Financial Institutions”, Athens Journal of Law, Volume 2, Issue 1, pages 49-60, 2016
4. European Commission website, https://ec.europa.eu/growth/content/green- paper-entrepreneurship-europe-0_en and Official website of the European Union, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52011DC0164
5. ICGN’s letter to Věra Jourová, EU commissioner for DG Justice and Consumers, sent 29 January 2015: www.icgn.org/sites/default/files/EC%20-
6. %2029.01.2015.pdf.
7. M. Siri, “Corporate governance of insurance firms after Solvency II”, page 3-11 ICIR Working Paper Series No. 27/2017,
8. G. Bernardino, “Solvency II A way ahead”, Insurance Europe’s Solvency II Conference: two years and the two reviews, Brussels, 26 June 2018
9. Official website of the European Union, https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32009L0138
10. Official website of the European Union, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065
11. G. Ferrarini, “Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda”, Law Working Paper n. 347, 2017, available at www.ecgi.org/wp
12. R. Ayadi, “Insurance Regulation and Supervision in the EU: Report of a CEPS Task Force”, Brussels, 2006
13. EIOPA Homepage, Guidelines on system of governance, 28 January 2015, available at https://eiopa.europa.eu/
14. P. MANES, “Corporate Governance, the Approach to Risk and the Insurance Industry under Solvency II”, in M. Andenas – R.G. Avesani – P. Manes – F. Vella
15. – P.R. Wood (eds.), “Solvency II: A Dynamic Challenge for the Insurance Market”, Il Mulino, chapter IV, p. 115, 2017
16. Б. Јаневска – Неделковска и други, “Корпоративно управување во друштвата за осигурување во Република Македонија – Насоки –“, Скопје, октомври 2014 година