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Corporate Governance in Insurance: Key Regulatory Considerations

Corporate governance in insurance continues to be a growing focus among state regulators. The National Association of Insurance Commissioners (the "NAIC") adopted the Corporate Governance Annual Disclosure ("CGAD") Model Act and Model Regulation in 2014, which set forth requirements insurers will need to implement and disclose. Currently, 14 states (California, Connecticut, Florida, Idaho, Indiana, Iowa, Louisiana, Montana, Nebraska, New Hampshire, Ohio, Rhode Island, Virginia, and Vermont) have adopted the CGAD Model Act and 6 states (Florida, Iowa, Louisiana, Nebraska, Rhode Island, and Vermont) have adopted the CGAD Model Regulation. While not a current NAIC accreditation requirement, many expect universal adoption of both the CGAD Model Act and Model Regulation by many United States jurisdictions.

Corporate governance has also become an important focus for Financial Condition Examiners ("Examiners") who conduct on-site financial examinations of insurers on behalf of state insurance commissioners. Thus, regardless of a state's adoption of the CGAD models, regulatory scrutiny will be applied through the financial examination of companies. This article provides a high-level overview of key considerations Examiners assess with regard to an insurer's corporate governance structure. One useful tool relied on by Examiners is the "Financial Condition Examiners Handbook" (the "Handbook"), which has been adopted by the NAIC and provides guidance in the risk-focused examination process, including the insurer's business processes and controls. Insurance regulators, through enforcement of financial examination standards, emphasize the importance of establishing a self-sustaining risk management culture that is composed of competent individuals who are independently involved in the insurer's risk management activities.

In conducting examinations of insurers that are part of a holding company structure, regulators must determine the level at which annual disclosures must be made. Depending on how the group is structured, annual disclosures may have to be filed by the ultimate controlling party, an intermediate holding company, the insurance company, or by all three entities. The focus is on the level at which insurance operations are directly overseen (*e.g.*, parent company, holding company, or legal entity levels). Once Examiners determine the appropriate level of governance oversight, they will thoroughly examine each relevant company's corporate governance structure with a particular focus on its board of directors and management.

When evaluating the board and management, Examiners assess specific governance controls for capacity to manage specific risks, and determine whether an insurer's corporate governance structure sufficiently emphasizes the competency, independence, transparency, and cooperation of the company's senior management and board of directors. Specifically, state regulators will consider the following corporate governance benchmarks:

1) The insurance competency of members of the board of directors;
2) The nature of independent involvement by board members;
3) The channels of communication between board, management and internal and external auditors that are intended to create a culture of openness;
4) The adoption of a code of conduct for senior management;
5) Establishing sound strategic and financial objectives, giving adequate attention to risks;
6) Relevant business planning and proactive resource allocation;
7) Reliable risk-management processes across business, operations and control functions;
8) Corporate adherence to sound principles of conduct and segregation of authorities;
9) Assessment and verification of sound programs;
10) Objective and independent reporting of findings to the board or appropriate committees thereof;
11) Adoption of Sarbanes-Oxley provisions, regardless of whether mandated, including, but not limited to, auditor independence and whistle-blower provisions; and
12) Board oversight and approval of executive compensation and performance evaluations.

The Board of Directors

Regulators will evaluate the overall structure and operations of the board of directors and have conducted meetings with individual members of the board of directors, or, in certain instances, the entire board. These meetings often occur at the beginning of an examination period, especially when the company has experienced significant senior management turnover, or when there has been a change in the external auditor. The goal of these meetings is to obtain an overview of the general functions of the board and its responsibilities, as well as gaining a general understanding of the company's culture.

The importance of a competent and independent board of directors cannot be understated. Regulators are more focused on the need for board members to possess an appropriate degree of industry experience, knowledge, and skill, as well as managerial, technical, or other expertise that will allow it to effectively perform necessary governance and oversight responsibilities. In this regard, Examiners will consider factors such as the board's independence from management, experience of its members, and the extent of its involvement and scrutiny of management and company-wide activities and performance. Of critical importance will be the manner in which the board selects and sets objectives for management, as well as the mechanisms adopted by the board to monitor whether management satisfies those objectives.

Indeed, the board must demonstrate it maintains sufficient oversight and independence from management. In considering the issue of board independence, regulators may search for instances where the board has raised difficult or probing questions directed to management, and the manner in which directors monitor and oversee management activities. In essence, does the board constructively challenge management's planned decisions or scrutinize activities? The time for a passive board member has passed.

Good corporate governance requires board oversight over every aspect of a company's operations. To do so, boards will often delegate oversight duties to committees, such as audit, compensation, finance, nominating, and employee benefits committees. These committees, through their oversight roles, can each take responsibility for certain aspects of internal control. Some committee leaders may be interviewed during an examination to gain a better understanding of the key oversight functions performed by each committee. Regulators will also want to know how the board assigns responsibilities to these committees and monitors their performance.

Management

Examiners will interview management, beginning with senior management and cascading through to lower levels of management. These interviews lend focus, context, and practical overview to the examination process and can be a wide-ranging review of a number of issues, such as:

1) Corporate strategic initiatives;
2) External/environmental factors of concern to management;
3) Political/regulatory changes that might affect business;
4) Competitive advantages/disadvantages;
5) Management of key functional activities; and
6) The manner in which management establishes and monitors the achievement of objectives.

Many company and market-specific factors will go into the determination of who will be interviewed and the scope of additional information the Examiners may require. Examiners ultimately want to understand the nature of the processes and procedures employed by management, from the development of business strategies though the implementation of operations. They will want to inquire as to board direction and oversight and the flow of the decision-making process within the organization. They will inquire into the personnel and obtain information about their: (1) experience and background; (2) duties and responsibilities; (3) reporting structure; (4) ethics; (5) risk areas; (6) risk mitigation strategies; and (7) corporate strategies.

Ultimately, Examiners will seek a better understanding of management's philosophy and operating style by reviewing such factors as management's appetite for risk-taking. In doing so, they may evaluate past business strategies and the results of any risky behavior, including any economic or regulatory consequences. They will direct careful attention to management's philosophy and style, including attitudes toward financial reporting, conservative or aggressive selection of alternative accounting principles, conscientiousness and conservatism with which accounting estimates are developed, and attitudes toward information systems and accounting functions.

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