

## Corporate Governance for Insurers

January 26 2010

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### Corporate Governance Guidelines for Insurers

At the end of 2009 the Indian insurance market regulator, the Insurance Regulatory and Development Authority (IRDA), issued its Corporate Governance Guidelines for Insurers. This is a lengthy and comprehensive document containing a combination of specific measures and general guidelines to be adopted and implemented by Indian insurers by April 1 2010. The guidelines are supplemental to the requirements of the Companies Act 1956, the Insurance Act 1938 and any other law on the basis that where any provision of the guidelines conflicts with another enactment, that other enactment will prevail. However, where the requirements of the guidelines are more rigorous, they will take precedence.

There seems to be a number of driving forces behind these guidelines, including:

- the unprecedented revelations of the financial irregularities at Satyam;
- the impact of the credit crunch on a number of overseas insurers; and
- the perceived importance of the financial sector in general to Indian economic growth and the public at large.

Of equal importance is the fact that in the coming years a number of Indian insurers are expected to come to market for the first time. According to Section 6AA of the Insurance Act, the existing position is that the Indian promoter of an Indian insurer cannot hold more than 26% of the paid-up equity. For a newly formed insurer, a holding above 26% must be gradually brought down to 26%, starting at the latest from the 10th year after the insurer commenced business. A number of insurers will be commencing their 10th year in the near future and the IRDA has already announced that it intends to publish its guidelines on insurers making public offerings soon.

With this in mind, the IRDA has stated its belief that the relationship between the board of directors, senior management and shareholders is fiduciary, with an enhanced responsibility to protect the interests of all stakeholders. According to the IRDA, insurers need a corporate governance framework that clearly defines roles, responsibilities and accountability within the organisation, and that contains built-in checks and balances. In particular, and with specific reference to the IRDA's responsibility to protect the interests of policyholders, the IRDA wants to:

- ensure that insurers have in place corporate governance practices that maintain solvency;
- secure sound long-term investment policies;
- ensure that underwriting is carried out on a prudential basis; and
- ensure that where insurers are part of a conglomerate, there is overall risk management across the group and problems with one part is not spread to other parts.

The guidelines are intended to ensure that an insurer's corporate governance structure recognises the expectations of stakeholders and the regulator, and can address quickly non-compliance or weak oversight and controls.

#### **Significant owners, controlling shareholders and conflicts of interest**

The IRDA has taken the opportunity to reiterate certain existing rules and regulations - for example, the 26% cap on foreign holdings in Indian insurers and how that cap is to be calculated, and the requirement for prior IRDA approval of the transfer of shares either which exceed 1% of the share capital or which, after transfer, will leave one person holding 5% or more of the share capital (2.5% where banking or investment companies are involved).

The IRDA says that where there is a conflict of interest between shareholders, management and policyholders, the board's duty is to act in the interest of policyholders or prospective policyholders and to put in place adequate systems, policies and procedures to address potential conflicts of interest. These will include:

- board-level reviews of key transactions;
- disclosures of any conflicts of interest; and
- ensuring that auditors, actuaries, directors and senior managers do not simultaneously hold more than one position in an insurer that could lead to actual or potential conflicts of interest.

#### **Governance structure**

The IRDA suggests that even where insurers have not yet gone public, they should take steps to adopt Clause 49 of the Stock Exchanges Listing Agreement so that there is a smooth transition when they do eventually list. Included within the recommendations is the appointment of a board chairman with distinct executive and oversight responsibilities.

### Board composition

The board should comprise independent, competent and qualified directors who have sufficient time and commitment to fulfil their responsibilities and are familiar with the organisational structure, processes and products of the insurer. The size of the board should be commensurate with the scale, nature and complexity of the business.

Directors must satisfy criteria relating to integrity demonstrated in personal behaviour and business conduct, soundness of judgement and financial soundness. To this end, a due diligence enquiry must be undertaken on proposed directors and existing directors at the time of their appointment or reappointment, which is to be accompanied by a declaration. The information in the declaration must be validated annually.

The IRDA says that directors will be required to enter into a deed of covenant with the insurer "to ensure that there is a clear understanding of the mutual role of the company, the Directors and the Board in Corporate Governance".

The IRDA believes that it is "desirable" for at least one-third of the board to comprise independent directors. This fraction rises to one-half where the company has an executive chairman. The IRDA insists on at least two independent directors until listing.

No more than one family member or close relative (as defined in the Companies Act) or associate (eg, partner or director) should be on the board.

### Board responsibility

The board is ultimately responsible for the direction, control and governance of the insurer, to which end it should articulate and commit to a corporate philosophy and governance standards that will shape the insurer's level of risk adoption, standards of business conduct and ethical behaviour at the macro level. It should set a clear and transparent policy framework for the translation of its corporate objectives into practice.

In a recurring theme throughout the guidelines, the IRDA says that insurers need to consider the interests of all stakeholders, and particularly policyholders as a specific group. The board is specifically charged with developing policies that define ethical individual and corporate behaviour and ongoing, effective processes that ensure adherence to these strategies and policies for the fair treatment of policyholders and employees.

With Satyam no doubt in mind, the IRDA also specifically requires the board to develop policies that encourage employees to raise concerns or report possible breaches of law or regulations, with appropriate measures to protect against retaliation - in other words, a proper 'whistleblower' policy. Elsewhere in the guidelines, the whistleblower theme is revisited. For example, insurers are "well advised to put in place a 'whistle blowing' policy", and the appointed actuary and the statutory or internal auditors have a duty to 'whistleblow' to the IRDA if they are aware that an insurer has failed to take appropriate steps to rectify a matter which has a material adverse effect on its financial condition.

In further specifics, the board must have a policy framework in place to deal with:

- the identification, assessment, quantification, control, mitigation and monitoring of risks;
- compliance with board-approved policy and applicable law;
- observance of risk management and compliance policies;
- an internal audit function capable of reviewing and assessing the adequacy and effectiveness of and the insurer's adherence to its internal controls, as well as reporting on its strategies, policies and procedures; and
- the independence of the control functions, including the risk management function, from business operations, demonstrated by a credible reporting arrangement.

### Delegation of functions

The IRDA recognises that it is imposing significant corporate responsibility on the board and therefore expressly permits the board to delegate monitoring to committees of directors. However, such delegation does not absolve the board of its responsibilities. The following committees are mandatory:

- an audit committee;
- an investment committee, in relation to which the IRDA expressly warns against slavish reliance on credit rating agencies. Due to the importance of this committee, any new appointment or removal of any member must be approved by the board and notified to the IRDA within 30 days;
- a risk management committee;
- an asset liability management committee (mandatory for life insurers), with specific responsibility for assessing policyholder expectations at product and enterprise levels; and
- a policyholder protection committee.

### Senior management

#### *Chief executive officer*

The IRDA expects the chief executive officer (CEO) to be responsible for the conduct of the insurer's affairs in a manner that is not detrimental to the interests of policyholders and is consistent with the board's policies and directions. If the CEO resigns, the IRDA must be told and given reasons for the resignation. The IRDA will need at least a month to decide whether to consent to a replacement.

### **Actuary**

In order to assist the appointed actuary in the discharge of his or her responsibilities, he or she is to have access to information as required.

### **Auditors**

Again with Satyam in mind, according to the guidelines:

*"The auditors should possess the competence and integrity to alert the appropriate authorities promptly of any event that could seriously affect the insurer's financial position or the organisation of its administration or its accounting and of any criminal violations or material irregularities that come to his notice."*

### **Outsourcing**

Since the regulatory framework requires that an insurer be able to execute all functions in respect of insurance business within its own organisations, the IRDA has stated that an insurer should not outsource any substantive functions that have not received board approval and the express prior approval of the IRDA. Unfortunately, at present there is no guidance as to what constitutes a 'substantive function', but the IRDA has said that in due course it will issue guidelines on those functions that cannot be outsourced.

### **Relationship with stakeholders**

The IRDA considers a stakeholder to be any person, group or organisation that has a direct or indirect stake in an insurer. This includes anyone that can affect or be affected by the insurer's conduct, objectives and policies. The key stakeholders of an insurer include shareholders, employees, policyholders and supervisors. Other stakeholders could include creditors, service providers, unions, rating agencies, equity analysts and the community at large.

Stakeholders have an interest in the operations of the insurer in terms of its profitability (and thus its capacity to provide a return on capital to shareholders, hire employees, expand its operations and contribute to economic and social activity), and its ability to meet its obligations to stakeholders as they come due (thereby promoting trust and confidence in the financial system).

In order to protect the interests of stakeholders, the IRDA says that insurers must ensure complete transparency in operations and make periodic disclosures with financial statements that accurately and fairly represent the financial condition of the insurer and the soundness and long-term viability of its business.

### Compliance

Insurers are to take immediate action to achieve compliance with the guidelines within six months. Where compliance is not possible, insurers must write to the IRDA for guidance. Each insurer is to designate a compliance officer whose duty will be to monitor continuing compliance with the guidelines.

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*Originally edited by, and first published on, [www.internationallawoffice.com](http://www.internationallawoffice.com)*