Directors' School for Insurers in Costa Rica

Introduction to Corporate Governance

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SUGESE
Superintendencia General de Seguros
República de Costa Rica

TORONTOCENTRE
Global Leadership in Financial Supervision

Introduction to Corporate Governance

Objectives

The program has three main objectives:

1. **To describe how insurance supervision has been evolving at the international level, especially since the financial crisis;**

2. **To describe how these developments can be expected to impact the insurance supervisory framework here in Costa Rica, particularly with regard to standards of corporate governance;**

3. **To assist you, as company directors, to play an effective role within the new system, for the benefit of yourselves, your companies and the country as a whole.**

The Canadian Experience

The Canadian financial and financial regulatory environment in the 1960s:

- **stable and prosperous economy**
- **many years with no insolvencies**
- **supervisory system considered to be “first rate”**
- **But financial supervision was routine, transaction oriented and duplicated much work of the independent auditor.**

The Canadian Experience

In the late 1970s, early 1980s, significant changes begin to appear:

- **increasingly entrepreneurial, competitive climate for financial institutions**
- **soaring inflation and interest rates**
- **falling real estate prices and general turbulence in financial markets**
- **rapid technological change exacerbated competitive pressures.**

The Canadian Experience

After more than 50 years with no failures, there were 12 insurer insolvencies during the 1980s. Also 2 small banks failed in 1986, and in 1985 and 1986 alone there were 10 trust company failures.

What was happening? There were two initial presumptions by investigators, and they were linked:

- **The regulators must have been asleep at the switch.**
- **Failed institutions must not have been following the requirements of the law.**

The Canadian Experience

Formal investigations after the fact showed clearly that for insurers, the root cause *in every case* had to do with management and business decisions:

- **under pricing of business, cash flow underwriting**
- **overly rapid growth**
- **lack of underwriting controls**
- **related party transactions**
- **poor quality reinsurance and lack of effective risk management.**

The Canadian Experience

None of these matters were addressed by the insurance regulatory laws of the times.

The supervisor could only take action when the law was broken. Poor management and business decisions were not against the law!

Senior insurance executives and their boards of directors were not thinking about how to measure and control the business risks they were taking on.

Realization: In fundamental sense, traditional financial supervision could not have prevented the failures. Something different was needed . . .

The Canadian Experience

Canada started on a new path, <u>emphasizing corporate governance</u> (with risk management as an important element), leading to a completely different focus for the insurance regulatory framework:

- **Board of directors identified in law as responsible for overseeing management of the institution and making sure its business and other risks will be adequately assessed and mitigated in ways that will be commensurate with its capital and human resources.**

- **Basic role of supervisor changed from attempting to verify that everything within the institution was "ok", to verifying that the board of directors is fulfilling its responsibilities.**

What is Corporate Governance?

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

OECD

The Power of Corporate Governance

What is Corporate Governance?

Corporate governance refers to oversight mechanisms, including the processes, structures and information used for directing and overseeing the management of a company. It encompasses the means by which members of the board of directors and senior management are held accountable for their actions and for the establishment and implementation of oversight functions and processes.

OSFI – Canadian Financial Regulator

The Power of Corporate Governance

The Canadian Experience

25 years after moving to a corporate governance based supervisory framework, Canada has become a world leader in terms of its financial institution and supervisory record:

- **No bail-outs or other significant difficulties during the financial crisis of 2008/2009**
- **The World Economic Forum has ranked Canada's banking system as the most sound in the world, five years in a row**
- **No significant insurance or banking failures in past 20 years**
- **Many countries have been implementing versions of the Canadian model**

The Canadian Experience

The new playing field has not only hugely reduced losses to the public from failed institutions, but it has also benefited the institutions themselves:

- **reduced volatility of business returns**
- **higher and more stable returns to shareholders.**

Corporate Governance Feedback Loop

Board of Directors

Feedback and Direction

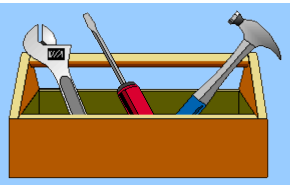
Information

Senior Management

Instructions

Information

Operations & Processes



Shop Talk segments

Corporate Governance Feedback Loop

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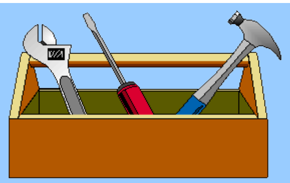

Shop Talk segments

Manage

Risks

Identify

Assess

Role of the Board – Overview[(1)]

Maybe add "eject"?

Direct:	the affairs of the company, establish appropriate policies and procedures for corporate governance and risk management
Protect:	the stakeholders, the company's financial position and assets
Connect:	with each other to form a collegial group for decision making
Expect:	appropriate governance and actions by management
Select:	the CEO
Correct:	the company's course when circumstances require
Inspect:	ensure that policies and procedures are adhered to.

(1) The Imperfect Board Member: Discovering the Seven Disciplines of Governance Excellence by Jim Brown.

Mini Case: Confederation Life

Background

- **Founded in 1871, Confederation Life was one of Canada's oldest and largest life insurance companies (US$20 billion in assets).**
- **Over 6,000 employees.**
- **Organized according to the mutual plan.**
- **Active in Canada, the U.S. and U.K., the company had 260,000 individual policyholders and another 1.5 million people who participated in group insurance plans.**
- **A.M. Best rated as "A" Excellent**

Mini Case: Confederation Life

- Around 1989, Confed appointed a new Chair and CEO, Pat Burns, a long time, successful marketing executive with the company.
- Mr. Burns was determined to make the company more entrepreneurial, to become Canada's largest life insurer.
- To accomplish this, he proposed that Confed should become a true financial conglomerate, diversifying into other areas of the financial field.
- Many "old time" employees, including actuarial and accounting professionals, were replaced with individuals who shared Mr. Burns' vision for the company.

Mini Case: Confederation Life

- **Mr. Burns wanted to see rapid growth in the company’s insurance business as well as in other financial services businesses.**

- **Within a year or two the company was growing at a rate that was 3 times faster than that of its competitors.**

Mini Case: Confederation Life

Strategic Initiatives

- **Making use of excellent Best's rating, balance sheet growth was partly funded by short term commercial paper with roll-overs.**

- **Aggressive pricing to increase life insurance sales.**

- **Aggressive future interest rate assumptions in new generation of interest sensitive products.**

- **Push for higher yielding investments with particular emphasis on mortgages, condo and real estate markets.**

Mini Case: Confederation Life

- **Diversification:**
  - **Acquired trust company (deposit taking)**
  - **Acquired leasing company**
  - **Entered into joint venture with condo developer**
  - **Construction financing**

In all of the above, Confederation adopted aggressive business stance to generate rapid growth.

Mini Case: Confederation Life

Discussion

- **Summarize the main risks to Confederation at this point in time.**

Mini Case: Confederation Life

Further Developments

- To grow quickly in fields where there was already stiff competition and experienced players, Confed had to adopt an increasingly aggressive posture.
- Real estate had been booming but in early 90s the boom turned to bust. 70% of Confederation's assets were real estate related.
- Confed's loan book through the trust company had been growing quickly (it's always easy to lend money!) and more than 50% of the trust company's loans were tied to the single condo developer jointly owned by Confed.

Mini Case: Confederation Life

- **Fee income was being taken into income immediately to boost reported profits, although the fees frequently related to longer duration situations.**
- **Trust company deposits were mostly broker-driven, i.e. deposit brokers move funds to institutions paying highest interest rates – and move them away when other institutions pay more.**
- **Increasing proportion of loans were becoming non-performing.**
- **Rumors on street that Confed financial position is questionable.**
- **Best's downgrades the Confed group.**
- **Large numbers of pension clients quickly begin to move their funds.**

Mini Case: Confederation Life

- Confed finds that it is unable to roll over commercial paper financing, leading to liquidity crisis.
- Liquidity crisis quickly leads to solvency crisis as clients move away, more loans become non-performing, huge write-downs required on real estate portfolio . . . End of story

. . . Except that Assuris, the life insurance policyholder compensation fund in Canada, is able to make sure that there is no loss to Canadian policyholders. And, the total cost of the failure to the compensation plan is only $5 million (because of early action by regulator and well-designed mechanisms by Assuris).

Mini Case: Confederation Life

Discussion

1. **In your view, what were the main underlying causes of Confederation's insolvency?**

2. **Should the regulators have intervened with regard to the new corporate strategy initiated by Mr. Burns and the board?**

3. **What was the board's role in this disastrous adventure?**

Thank you

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