FINANCIAL SERVICES TRENDS

ARE YOU READY FOR A CORPORATE GOVERNANCE REVIEW?

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Over the years, corporate governance has received greater focus from investors, regulators and anyone else trying to evaluate a company. The failure of Enron and the financial crisis of 2008 highlighted the importance of corporate governance as a barometer for corporate accountability and a necessity for avoiding such disasters. The National Association of Insurance Commissioners (NAIC) undertook a multi-year self-examination of its regulatory framework for United States insurance companies, studying and comparing existing governance requirements and best practices. A number of enhancements were proposed to strengthen corporate governance standards. One, the Corporate Governance Annual Disclosure Model Act, was approved in an effort to assist the regulators in better understanding how an entity is managed and controlled.

The Corporate Governance Annual Disclosure Model Act ("Act"), and supporting Model Regulation, were approved by the NAIC in November 2014 to become effective in January 2016. However, like all model acts, individual states must adopt the acts as part of their insurance regulations in order for them to be effective. As of the 3rd quarter of 2016, approximately 10 states have adopted the Act although all states are expected to adopt it over the next few years. While the pace of adoption may be slower than some expected when the Act was approved, the essence of the Act is broadly supported and will be a mainstay of future insurance regulation.

The Act provides insurance regulators with a method of assessing corporate governance structure, policies and practices annually. It requires insurers to provide a confidential disclosure regarding its corporate governance practices. Two interesting points to note with this particular Act: 1) there is no prescribed form of report or checklist and 2) it applies to insurers of all sizes.

With regard to the format of the report, the insurer has the discretion to choose a format that is appropriate in their circumstances. They can customize the information to provide the relevant information to allow their state regulator to understand their governance approach. The NAIC does, however, requires that the following items are addressed:

- The insurer's corporate governance framework and structure;
- The policies and practices of its board of directors and significant committees;
- The policies and practices directing senior management; and
- The processes by which the board of directors, its committees and senior management ensure an appropriate level of oversight to the critical risk areas impacting the insurer's business activities.

The NAIC has routinely exempted small insurers (premiums < $500 million) from other model acts or disclosure requirements. However, in this case, the NAIC made a definitive decision to include small insurers. The NAIC reiterated the need for small insurers to focus on improving their corporate governance structures, strengthening their risk management and updating the knowledge and qualifications of their Board members. Many smaller insurers typically have had very paternal or familial management or governance structures. While effective in a business sense, this type of structure is usually more informal that most large insurers and probably evolved over time as opposed to being part of a specific strategy.

These disclosure requirements may be redundant for large insurers as they would have addressed most of these items in their ORSA (Own Risk and Solvency Assessment), Holding Company report or other SEC/regulatory filings. Small insurers, however, may find the assessment and documentation of their governance structure to be more time consuming and thought provoking. It may even prompt some structural or procedural changes. In the end, the free form disclosure adopted by the NAIC may benefit them as they can tell their story to the regulator and provide assurance that the structure, policies and processes are appropriate for a company of their size and risk profile.

The reality is that regulatory focus has changed for all companies, with regulators intent on understanding how companies are set up to operate going forward as opposed to merely reviewing the financial results of the past. A well thought out governance framework that complements the insurer's operations, strategic plan and risk management will benefit both the regulator and the insurer. Insurers should monitor the adoption of the Corporate Governance Annual Disclosure Model Act by their domiciliary states and be prepared to comply with the necessary reporting requirements.

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