ISSN 2250-3153

Corporate Governance and Risk Management in Insurance Sector: A review of literature

Bhavya Bansal[1], Aishvarya Bansal[2]

[1] Post graduate scholar, Deptt. Of Commerce
[2] Assistant professor, Deptt. Of Commerce

Abstract- "Better governance leads to better management". This paper shall be useful for increasing the knowledge and awareness of how critical and crucial corporate governance is, especially after the financial crisis that led to a recession in the worldwide economy. This paper is an insight for corporate governance and risk management strategies adopted in different insurance industries across the globe. Because corporate Governance is not only mandatory but also recommended so that companies adhere to best practices. It will correlate the theories formulated for corporate governance and actual practices followed in insurance companies. This paper will brief out the existing literature on this topic along with the results derived from these studies. Finally, it will conclude with recommendations and suggestions based on existing studies.

***Index Terms*-** Corporate Governance, Governance, Insurance Companies, Risk Management

I. Introduction

"Corporate Governance is the system by which companies are directed and controlled" as said by Sir Adrian Cadbury Report of the Committee on the Financial Aspects of Corporate Governance.
(London: Gee and Co. Ltd., 1992).

A country's economy depends on the drive and efficiency of its companies. Therefore, the effectiveness with which directors discharge their responsibilities determines country's competitive position. The board of directors must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability – the essence of good corporate governance.

The genesis of Corporate Governance lies in business scams and failures. The Watergate scandal, the junk bond fiasco in USA and the failure of Maxwell, BCCI and Polypeck in UK resulted into setting up of the Treadway committee in USA and the Cadbury committee in UK on Corporate Governance.

The guiding principle being "transparency and ethics" should govern corporate world. Increasing strategic importance of professional management probably constitutes the most important aspect of changing profile of Corporate Governance. Given the global challenges, the only choice left with business and economic enterprises is to follow the Corporate Governance practices – the path for living, working, surviving, successing and the excelling in the future.

This paper investigates corporate governance norms followed in insurance companies and its scope of improvement. During the last 25 years India's Insurance industry witnessed significant consolidation and a strengthened regulatory framework with the establishment of the IRDA as its regulator.

"In fact, risk management through insurance is as much an art as a science."

II. Analysis of Existing Studies with Results and Findings

A good number of theoretical and empirical researches on corporate governance disclosure in insurance sector have been undertaken throughout the globe by both individual researchers and consultancy firms. Review of some existing literature is as under:

- Eling and Marek, in 2011, examined that one recent exception relates to the risk-taking behaviour of European insurance companies from the United Kingdom and Germany. Their research showed differences between the market-based U.K. corporate governance environment and the control-based system that prevails in Germany.

Using a sample of 276 firms between 1997 and 2009.Their corporate governance indicators included executive compensation, supervisory board compensation, and independence, as well as the number of board meetings and ownership structure.

Result: The study concluded that U.K. insurance firms engage in more risk taking than their German counterparts and that large shareholdings and concentrated ownership contribute to increase risk taking.

- Mayers and Smith, in 1992, studied a particular feature of the property-liability insurance industry in terms of corporate governance. Their study examined that insurance firms exhibit different governance characteristics, particularly their organizational structure (mutual versus stock insurance companies).

Result: Agency theory arguments hold that mutual insurance companies are better able to control conflicts of interest between policyholders and owners whereas stock insurance companies control better the conflicts between owners and managers.

- He and Sommer, in 2011, sustained that insurance companies are subject to different governance systems.

Result: Mutual company managers have less control and are monitored by the BODs, while stock insurers' managers are monitored by both internally and externally. Their study further revealed that stock firm's managers have managerial ownership, block ownership, institutional ownership, while, mutual company managers are precluded from such monitoring mechanisms.

- Cheng, Elyasiani, and Jia, in 2011, investigated the link between risk-taking behaviour of life-health insurers in relation to their institutional ownership. To determine whether institutional investors serves as a substitute for regulation, after controlling using simultaneous equations.

Result: Institutional ownership stability reduces total risk through an increase in leverage of underwriting risk and investment risk.

- Lai and Lee, in 2011, studied particular organizational structure of the U.S. PC insurance industry to assess the link between corporate governance and risk taking They argued that "the stock organizational structure may encourage to take more risk and thereby increase the wealth of shareholders." Indeed, shareholders, who have limited liability, are more likely to take risk in order to maximize firm value. In the mutual organizational structure, it is "policyholders who bear the consequences of insolvency, and thus maintain a low level of risk taking" (Cummins and Nini, 2002).

Result: It confirmed that mutual insurers have lower underwriting risk, leverage risk, investment risk, and total risk than stock insurers because, their risk is shared mutually. It also showed that all types of risks (i.e., underwriting, leverage, investment, and total risk) are higher when BOD's size increases or when number of independent director reduces.

- Firth and Liau-Tan, in 1998, studied that available empirical evidence documents, particularly the audit quality, has a mitigating effect on risk taking.

Result: Poor audit quality means higher risk.

- Adams, Alemida, and Ferreira (2005) study on alternative governance mechanisms to risk taking revealed that firm with dual CEOs exhibit high risk-taking behaviour **Result:** They interpreted that, CEO who has more power " the likelihood of very good or very bad decisions is higher" in comparison to firms who's CEO has less power in the decision-making process.
- In a recent study Boubakri, Dionne, and Triki studied that CEO duality is positively related to mergers and acquisitions in the insurance industry. This evidence in the insurance industry is at odds with the argument in Bebchuk and Weisbach (2009) **Result**: It former it shows that CEO duality is costly to shareholders and worsens agency conflicts within the firm. In the latter, it shows that CEO may want to protect his job and hence should be more risk averse.
- He, Sommer, and Xie, in 2011, studied CEO turnover (Based on a sample of U .S. property-liability insurance firms. Study held that firms with a CEO turnover have more favourable performance measured by revenue and cost efficiency.

Result: Study confirmed that accounting performance measured by return on assets (ROA) is higher after CEO changes.

- Downs and Sommer (1999) showed that Insider ownership as an internal governance mechanism is theoretically expected to lower firm risk and increase firm value. Study shows that managers in the property-liability insurance firms are more likely to undertake highly risky activities when their stakes in the firm increase from low levels, but this relationship reverses after managerial ownership goes beyond the 45 percent threshold, indicating nonlinearity of the relationship between risk and managerial ownership.

Result: Confirms earlier evidence in Morck, Shleifer, and Vishny (1988) and later in Cho (1998) that managerial ownership and firm performance exhibit a nonlinear relationship, with an incentive effect at low levels of managerial ownership and an entrenchment effect at higher levels of ownership.

- Lai and Lin studied in 2008 the important internal governance mechanism in the insurance industry, namely the BODs. They showed that in the U.S. property-casualty insurance industry that asset risk is lower and total equity risk and higher when board size increases. Brick and Chidambaran in 2008 also found that board independence (higher proportion of outside directors) is negatively related to firm risk. MacCrimmon and Wehrung (1990), however, documented that a higher percentage of executives on the board will lead to *less* risk taking.

Result: If BOD size increases total equity risk increases. But if composition of BOD has more independent directors then with increase in BOD size risk reduces.

- Cheng, Elyasiani, and Jia (2011) studied the influence of institutional investors on risk taking in insurance firms. The authors reported that institutional investors owned 54 percent of life-health insurers' stocks and 59 percent of property-casualty insurers' stocks over the period 1992-2007.

Result: Institutional investors put more pressure on managers this is how they reduce risk, reduce overall cost of capital of the firm and satisfy both shareholders and regulators. Since, wealth of institutional investors is highly concentrated so they are more risk averse.

- Karim et al. (1996) argued that annual reports of the companies should be considered as the most important source of information about a company.

Result: Corporate Governance practices of a company can best be judged from its annual reports and financial statements.

- Reddy (1998) recommended that the positions of chairman and managing director should be vested to one person in public companies to protect the interests of the organisation. The major challenge in progressing to good corporate governance is to build essential knowledge on relevant laws, duties and responsibilities, financial analysis, strategy, business ethics and effective decision making.

Result: A single individual is enough to act both as CEO and MD in a public company till he has entire knowledge of law.

- Joh (2003) presented evidence on corporate governance and firm profitability from Korea before the economic crisis.

Result: Weak corporate governance systems allowed poorly managed firms to stay in business and resulted in inefficiency of resource allocation, despite low profitability over the years.

- As per the survey report of 30 geographically distinct companies presented in the 21st Session of International Standards of Accounting and Reporting (Geneva 27-29 October, 2004), by UNCTAD Secretariat it was found that there is an increasing convergence among national and international corporate governance codes and guidelines. It also reported significant deviation in disclosure practices, irrespective, of the business goal. However, it reported certain good corporate governance practices between countries.

Result:

- It promotes efficient use of scarce resources both within the organization and the larger economy.
- It makes the resources flow to those sectors where there is efficient production of goods and services and in return satisfies the demands of stakeholders.
- It provides a mechanism for choosing the best managers to administer the scarce resources.
- it helps the managers to constantly focus on enhancing the company performance
- It puts pressure on the corporation to abide by the law as well as achieve corporate social responsibility.

And finally, it assists the supervisors in regulating the entire economic sector.

III. CONCLUSION

Corporate governance practices differ according to the nature of insurance industry, composition of BOD, independent directors, risk taking characteristics and such other features. Undoubtfully every company is following corporate governance norms in one or the different manner according to the laws, guidelines, code of ethics, corporate social responsibility prevalent in the country. The extent to which company adheres to good corporate governance showcases its honesty in compilation of financial records.

Corporate governance also includes risk management since for some insurance companies risk cannot be diversified and therefore their business is always at risky stake. Adherence to governance norms brings simplicity and dilution of risk in such companies in form of lenient regulations, stakeholders and government support. Thus, the studies reveal the ever growing importance of corporate governance and risk management in insurance sector.

REFERENCES

[1] IRDA (2009). Corporate Governance Guidelines for Insurance Companies. India.

[2] K. N. Vaidyanathan and Uday Sathe, 2013, Risk Management, Chartered Secretary, August 2013, pp.275-280

[3] Naresh kumar, 2011, Risk Management and Insurance in the Emerging Scenario, Chartered Secretary, Dec 2011, pp513-519

[4] Rajesh Chakrabarti, 2006. The Financial Sector in India – Emerging Issues, (With a Foreword by Richard Roll), Oxford Press, New Delhi, India.

[5] Erkens David, Hung Mingyi, & Matos Pedro, (December 2009), "Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide"

[6] A. Ghosh, 2006, "Determination of Executive Compensation in an Emerging Economy: Evidence from India', Emerging Markets Finance and Trade 42, pp.66-90.

[7] Bushman, Robert M., and Abbie J. Smith. 2001. Financial Accounting Information and Corporate Governance. Journal of Accounting & Economics 32(1-3): 237-333

[8] Shleifer, Andrei and Robert W. Vishny. 1997. A Survey of Corporate Governance. The Journal of Finance. 52 (2): 737-783.

AUTHORS

First Author – Bhavya Bansal is a post graduate scholar and has to her credit various research articles. She has interest in area of human resources, business analysis of corporates research, comparative analysis of HR policies followed in big multi-nationals. She is a fellow of various allied bodies successfully running countrywide.

Second Author – Aishvarya Bansal has to her credit numerous publications and research article. She has keen interest in area of human resources, marketing, laws, and business analysis of HR policies. She is fond of teaching and research. She has supported many research projects before eminent institutions in the country; Email:aishb_2010@yahoo.com