CORPORATE GOVERNANCE IN INSURANCE SECTOR

Priyanka Chaudhary*

ABSTRACT

Currently, the way in which companies are managed and controlled in India is intensely being scrutinized consequently pushing the subject of corporate governance to the top of the agenda. The focus on corporate governance is particularly crucial in financial services and, most of all, in the insurance sector since this sector has lately become highly exposed to public scrutiny and has learned, in a costly manner, the risk of attracting adverse publicity through failings in governance and stakeholder relationships.

The importance of responsibility, accountability, transparency and fairness are raising the issues of their effect on the performance of the firm and the managers as well. This is closely related to the agency problem because corporate governance mechanisms intend to induce managers to act according to the best interest of the shareholders, which is by maximizing the firm's value and ultimately reducing agency costs.

This study is a contribution to other studies conducted to examine the impact of corporate governance mechanisms on firm's performance of the insurance industry in India, understand how to minimize the agency costs effectively and design the appropriate organizational structure. Also, to distinguish between good and bad corporate governance which is a crucial step in building the market's confidence and attracting positive investment flows to the institution and the economy.

The researcher suggests that every insurance firm should properly define corporate governance and its mechanisms and implement them effectively in order to reach the firm's long-term goals, build stakeholders' confidence and generate positive investment flows.The recent financial crisis has had enormous impacts on the economy, leading to major problems in insurance companies. Therefore, an insurance company should focus on good corporate governance that will build a stable foundation for recovering from this crisis.

Keywords: *corporate governance, firms performance, insurance sector.*

*Assistant Professor, Delhi School of Management, Delhi Technological University, Bawana Road, Delhi, India

INTRODUCTION

According to the Financial Stability Forum (2001), among the main factors the support the stability of any country‘s financial system include:

- good corporate governance
- effective marketing discipline,
- strong prudential regulation and supervision,
- accurate and reliable accounting in financial reporting systems,
- a sound disclosure regimes,
- the enforcement of effective laws,
- an appropriate savings deposit protection system.

Corporate governance has become a topical issue because of its immense contribution to the economic growth and development of nations. The absence of good corporate governance is a major cause of failure of many well performing companies. Existing literature generally support the position that good corporate governance has a positive impact on organisational performance; OECD (2009), ACCA, (2008), Gompers et al, (2003), Claessen et al, (2002) and others. The economic well being of a nation is the reflection of the performance of its companies. Thus the low level of development of developing nations is attributed to the low level of good corporate governance practices. As a result such countries have been identified by the World Bank and other writers as having inadequate capacity to effectively manage their resources. Hence the emphasis placed on good corporate governance in the existing literature as the most important problem facing the development of countries, such as India.

The concept of corporate governance has been defined as “dealing with the ways in which suppliers of finance to corporations assures themselves of getting a return on their investment” (Shleifer andVishny, 1997, p.737). It deals precisely with problems of conflict of interest, design ways to prevent corporate misconduct and aligns the interests ofstakeholders using incentive mechanism (Shleifer and Vishny, 1997). Good corporate governance is a desired feature of aliberalized market to ensure the flow of both foreign and domestic capital for accelerated economic development. This is because it increases investor confidence and goodwill, ensures transparency, fairness, responsibility and accountability. Gompers et al. (2003) maintained that good corporate governance increases valuations and boost the profitability of the firm.

According to Claessen et al. (2002) better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders. Donaldson (2003) posit that good

corporate governance is important for increasing investor confidence and market liquidity. According to Frost et al. (2002), improvements in corporate governance practices that contribute to better disclosures in business reporting in-turn can facilitate greater market liquidity and capital formation in emerging markets.

The insurance industry is an important component of the financial sector of the economy because of its financial intermediation role. They give protection to policyholders by guaranteeing the safety of their investments against accident and thereby promoting business activities in the country. As a result of the peculiar characteristics of the insurance industry and the significant contributions that is making to the development of the economy coupled with the non existence of such

study, there is a strong ground to conduct this research. This article is organised in four parts: the introduction, review of relevant literature, followed by the methodology, discussion of the results and the conclusion.

LITERATURE REVIEW

The concept of insurance, according to (Gollier C., 2003), involves pooling funds from many insured entities (known as exposures) in order to pay for losses which can occur to these entities. The insured entities are therefore protected from risk for a fee - premium, with the fee being dependent upon the frequency and severity of the event occurring. In order to beinsurable, the risk insured against must meet certain characteristics. Insurance is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses. The requirement to promote good corporate governance, both within and outside the financial services sector, is receiving increased international attention. The IAIS has therefore decided to produce a compilation of the Insurance Core Principle on Corporate Governance which outlines the standards and guidance notably related to various corporate governance aspects, to provide a comprehensive set of regulatory and supervisory best practice on this issue. More importantly, it is proven that countries with good and reliable corporate governance tend to have developed markets where the economic growth can be stimulated, especially with those which rely heavily on external finance and have weak

legal environment. So, we can conclude that corporate governance is not only important to the operating performance and firm's value, but also to the whole country at a macro level (Sapovadia, 2009).

As mentioned before, the financial scandals that hit the market in recent years, and the collapse of so many institutions such as Enron, WorldCom, Commerce Bank and XL Holidays, aligned with the recent financial crisis, forced the firms to concentrate more on good corporate governance and to develop and implement several effective mechanisms in order to have the investors' confidence and faith back again (Young, 2003). According to the Insurance Regulatory and Development Authority in India (IRDA, 2009), the regulatory responsibility to protect the welfare of the policyholders demands that insurance firms have in place, good governance practices for the maintenance of sound long-term investment policies, solvency and underwriting risks on a prudential basis. Any governance principles adopted by the insurance industry should be flexible enough to take into account the variety of insurers within its purview, because obviously "one size doesn't fit all" and each insurance company tailors its corporate governance procedures according to its own circumstances.

According to a research conducted by (Mustafa, et al, 2009) internal control and auditing is a critical dimension of corporate governance. The oversight and reporting systems will allow the board and management to monitor whether the operations are conducted in accordance with the firm's policies or not. It also provides a foundation for the safety and soundness of the insurer and a systematic and disciplined approach for evaluating and improving the effectiveness of the work process and its compliance with the regulations. Mustafa, et al (2009) also mentioned that every insurance company should maintain accurate and verifiable records of all the transactions made. These records include: a premiums register, a premiums ledger, premium reports, a claims register, claims reports, a general ledger, an income statement, and a balance sheet. Each insurance company should audit their accounts and the financial reports annually by their internal audit committee and an external legal audit firm. The audit firm should report directly to the CBB if any fraudulent actions are committed by the insurer.

Why is Corporate Governance Imperative in Insurance?

- Insurance is a long-term business with uncertainty of risks and returns.An average policy matures over 20 years
- Fiduciary relationship - Custodian of large scale public money and Settleclaims judiciously to ensure beneficiaries
- None of the company in Indian insurance sector is yet listedPublic disclosure of financials not mandatory
- Financial sector is crucial for economic development & growth. Hencemore intensive framework required
- Insolvency risk is inversely related to the quality and experience ofsenior management
- Protect interest of stakeholders (mainly the policyholders) andrecognize their expectations, including those of regulator.

CONCLUSION

The adoption of good corporate governance practices enhances transparency of company's operations, ensuresaccountability and improves firm's profitability. It also helps to protect the interest of the shareholders by aligning their interest with that of the managers. The study examined the relationship between corporate governance and its impact on the performance of insurance companies. The results show that generally corporate governance has positive impact on profitability. The

factors of board size, board and management skill, CEO tenure, size and independence of audit committee, foreign and institutional ownership, dividend policy and annual general meeting, all have positive correlation with the performance of the insurance companies.

The study shows that the insurance companies must have the right board size which is highly independent from the management of the company and with the appropriate skills. This would ensure that the board is well diversified and have the competence to give the strategic direction of the company. Also being able to monitor management and ensure that internal controls are instituted and working. The annual reports and the financial statements of the companies are the main means of communication between the company and the stakeholders. Therefore the sensitive role of the audit committee by ensuring that the financial statements show the true position of the company's performance cannot be overemphasised. The audit committee must be well constituted to increase its independence and with the right size. Again the evidence shows that foreign and institutional shareholders bring a lot of advantages to the local companies that improve their performance. The companies should take measures to attract these all important segment of the investor population.

Furthermore, the result is an indication that the insurance companies are well positioned to support the economic growth and development of the country. With good corporate governance record, the companies would be able to generate more

resources to create more employment opportunities, support businesses through prompt payment of accident claims, pay dividend to shareholders and generate more tax revenue to government. Again, through efficient management of their financial resources, they would be able to support the growth of investment in the economy through their financial intermediation role by channeling resources to the critical areas of the economy.

RECOMMENDATIONS

1- The researcher suggests that every insurance firm should properly define corporate governance and its mechanisms and implement them effectively in order to reach the firm's long-term goals, build stakeholders' confidence and generate positive investment flows.

2- The recent financial crisis has had enormous impacts on the economy, leading to major problems in insurance companies. Therefore, an insurance company should focus on good corporate governance that will build a stable foundation for recovering from this crisis.

3- Regarding future line of research, efforts should be put at increasing the sample size, the corporate governance variables, and the time frame in order to have more accurate and reliable results.

4- More importantly, the empirical literature indicates a sample selection bias in favor of very big firms. It is hereby suggested that attention should be devoted to the study of small- and medium-scale firms. This is because these firms account for at least 90% of the total number of firms in the world.

BIBLIOGRAPHY

- Gollier, C. (2003). To Insure or Not to Insure? An Insurance Puzzle. The Geneva Papers on Risk and Insurance Theory. March.
- IRDA (2009). Corporate Governance Guidelines For Insurance Companies. India.
- Mustafa, M., Osmani, S., Elmazi, S., Tosuni, G. &Aliu, F. (2009). Improving Corporate Governance And Transparency In Banks And Insurance Companies In Kosovo. Reinvest. April.
- Sapovadia, V. (2009) Good Corporate Governance: An Instrument For Wealth Maximization.
- Young, B. (2003). Corporate Governance and Firm Performance: Is there a relationship? Ivey Business Journals. September-October.
- Claessens, S., Djankov, S. & Fan, J. P. H. (2002). Disentangling the incentive and entrenchment effects of large shareholders.The Journal of Finance, 57(6), 2741-71
- Donaldson, W. (2003). Congressional testimony concerning the implementation of the Sarbanes-Oxly Act of 2002.
- Frost, C. A., Gordon, E. A., and Hayes, A. F. (2002). Stock exchange disclosure and market liquidity: An analysis of 50international exchanges. Kuala Lumpur, paper presented at the World Federation of Exchanges Forum on managingexchanges in emerging economics.
- Gompers, P. A., Ishii, J. L., &Metrick, A. (2003). Corporate governance and equity prices. Quarterly Journal of Economics,118(1), 107-55
- Shleifer, A., &Vishny, R. (1997). A survey of corporate governance. Journal of Finance, 52(2), 737-783