CORPORATE GOVERNANCE PRACTICES OF THE INSURANCE INDUSTRY IN SOUTH AFRICA

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Abstract

The insurance sector plays a critical role in any economy by its very mechanism of risk transfer and savings mobilisation. It thus performs a critical role in intermediation by fostering the liquidity of the financial markets. This in turn ensures that capital is transferred from surplus units to deficient units of the economy who are in need of funds for the undertaking of capital projects and thereby spurring productivity. In the aftermath of the 2007 to 2009 financial crisis the insurance industry image was tainted. As such, the observance of good corporate governance tenets has now more than ever before become quintessential and also a prescription by regulators. The purpose of this paper is to explore the corporate governance practices (both internal control as well as regulatory measures) that are prevalent in the South African Insurance industry. This paper utilised qualitative research methods and lend itself to document analysis of company reports that the insurance companies submit, as well as the Acts and industry codes that governs the insurance industry in South Africa. The Atlas.ti software was used to analyse the documents. We find evidence that insurers are at various stages of embedding good corporate governance practices. In the aftermath of the financial crisis, the insurance companies by and large have strengthened their internal control systems. They have also complied with regulatory directives and are grappling with the implementation of Treating Customers Fairly (TCF) as well as Solvency Assessment Measurement (SAM) which are market conduct and prudential regulations respectively. Further they also subscribe to the King I, King II and King III frameworks of corporate governance. However we wish to caution against "over regulating" this sector as this could stifle innovation.

Keywords: Corporate Governance, Insurance Companies, Regulation, Internal Control, South Africa

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1 Introduction

Embedding good corporate governance practices continues to be a preoccupation of regulators and those vested with the fiduciary role of safeguarding shareholders' interests alike. There is an impelling need to investigate how this process has unravelled in the insurance sector. The motivation in selecting the insurance sector is that it plays a critical role in any economy by virtue of its ability to mobilise savings as well as to operate as an agent of risk transfer. The 2007-2009 global financial crises brought to the fore the importance of financial sector stability to the general wellbeing of economies. Attendant to securing the financial sector would be to ingrain good corporate governance practices either by way of internal controls or by strengthening existing regulation.

The 2007-2009 global financial crises have been partly explicable as a result of poor corporate governance practices. The failure of banks and insurance companies in the developed world came at a huge cost (Brunnermeier, 2009). It is instructive to highlight that the world economy receded. Similarly South Africa entered a period of recession in 2009 with the Gross Domestic Product contracting by minus 1,8 per cent. The financial sector in South Africa comprises over R6 trillion in assets, contributes 10,5 per cent of the Gross Domestic Product per year, employing 3,9% of the employed and contributes at least 15 per cent of corporate income tax (National Treasury, 2011). Although South Africa has sound macroeconomic fundamentals and a robust financial regulatory framework it suffered more proportionately as compared to other G-20 countries. It is estimated that close to 1 million jobs were lost during the same period (National Treasury, 2011).

The impetus behind this study is to establish the adequacy of the corporate governance practices of the South African insurance industry. The present study aims to contribute to the corporate governance literature by specifically focusing on the insurance sector in the context of South Africa. Hitherto the studies that have been conducted have largely focused

on the moral hazard effect of Directors' and Officers' (DO) insurance coverage (See for example, Baker and Griffith, 2007; Core, 2000; O'Sullivan, 1997). It could be argued that South Africa presents itself as the best case study as it has a very diverse culture, its financial system has improved vastly over the years and attendant to this the regulatory environment has also evolved over the years (Sibindi, 2014 ; Sibindi and Godi, 2014).

In this article we shall carry out a two pronged approach to investigate the adequacy of the corporate governance practices embraced by the South African insurance industry. Firstly we shall focus on internal control governance practices that are employed by the insurance sector as envisaged in the King III report. The second prong will be to appraise of the external corporate governance measure in essence which is the insurance regulatory landscape. To this end there has been a raft of regulatory reforms that have been promulgated. In the aftermath of the 2007-2009 financial crises the regulatory response was to institute the so called "twin peaks" regulation. These peaks are financial stability or prudential regulations and the market conduct regulations. A raft of reforms has been implemented and include amongst others, the Solvency Assessment Management (SAM) regime whose main aim is to improve the capital and solvency levels of insurance companies. The second categories of regulations that have been implemented are targeted at market conduct and include amongst others the Treating Customers Fairly (TCF) regulations which are aimed at protecting the insurance consumers. We thus also hope to chat the way forward for policy makers in South Africa as they grapple with policies that are aimed at securing the financial sector, specifically targeted at the insurance sector.

The remainder of paper is arranged as follows: the next section provides an overview of the insurance sector in South Africa. Section 3 reviews the related literature. Section 4 reviews the insurance regulatory framework. Section 5 discusses the internal corporate governance measures adopted by the South African insurance industry and then Section 6 concludes.

2 An overview of the insurance sector in South Africa

The insurance sector in South Africa comprises of 79 long-term insurers and 7 long-term reinsurers, 100 short-term insurance companies and 8 short-term reinsurance companies (FSB, 2012). In South Africa the insurance companies that transact life insurance business are referred to as long-term insurers. Similarly the companies that transact non-life (property) insurance are referred to as short-term insurers.

The key metrics of the insurance companies for the period 2011 to 2013 are given in Tables 1 and 2 below. The gross premiums of long-term insurance companies show a remarkable growth of 43% from about R301 billion registered in 2011 to roughly R430 billion registered in 2013. On the other hand the premiums of short-term insurance companies show steady growth of 19% from about R81 billion registered in 2011 to the levels of about R96 billion registered in 2013. A similar trend is observed when evaluating the total assets with the long-term insurance industry registering a phenomenon growth in total assets of 32% from roughly R1, 7 trillion in 2011 to R2, 3 trillion in 2013 as compared to the short-term insurance industry which shows steady growth of about 23% from roughly R90 billion in 2011 to R112 billion in 2013.

The information provided in Table 2 depicts the investment vehicles of the insurance companies. Thus it would seem that the insurance companies both long and short-term play a critical role in intermediation, savings and resource mobilisation.

Table 1. Gross premiums and total assets of insurance companies in South Africa

	2011		2012		2013	
	Long-Term Insurers	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**
Gross Premiums / R'mil	300 650	80 951	358 967	87 675	429 703	96 178
Total Assets / R'mil	1 722 777	90 472	2 000 555	101 547	2 278 148	111 686

Source: authors' own compilation, data from FSB (2013)

3 Review of related literature

The most apt definition of corporate governance was perhaps by given by Shleifer and Vishny (1997). They observe that corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers? Corporate governance influences the efficiency of firm production at the corporate level, so that the effectiveness of a nation's corporate governance system shapes economic performance at a country level. Standard agency

theory defines the corporate governance problem in terms how equity and debt holders influence managers to act in the best interests of the providers of capital. To the extent that shareholders and creditors induce managers to maximize firm value, this will improve the efficiency with which firms allocate resources (Caprio and Levine, 2002). In essence these definitions of corporate governance encapsulate the agency problem.

Table 2. The investments composition of insurance companies in South Africa

	2011		2012		2013	
	Long-Term Insurers	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**
Cash and deposits / R'mil	205 790	37 634	221 377	41 780	193 901	42 224
Government and semi-government / R'mil	191 549	6 963	173 874	9 597	178 194	11 888
Equities /R'mil	862 648	25 813	1 221 629	28 605	1 470 533	29 946
Debentures and loan stock / R'mil	128 379	1 666	176 585	1833	215 743	1903
Immovable Property / R'mil	58 833	-	58 152	-	49 571	-
Fixed Assets / R'mil	181 838	1 004	2 112	842	2 367	1 091
Debtors / R'mil	94 965	7 265	118 589	7 980	133 930	9 027
Outstanding Premiums / R'mil	-	5 815	-	7 016	-	8 375
Other Assets / R'mil	0	4 311	28 235	3 893	33 909	7 231
Total Assets / R'mil	1 724 002	90 472	2 000 555	101 547	2 278 148	111 686

Source: authors' own compilation, data from FSB (2013)

Davis (2002) buttresses the agency viewpoint further and observes that, given the divorce of ownership and control in corporations, principal-agent problems arise, as shareholders cannot perfectly control managers acting on their behalf. Managers have superior information about the firm and its prospects, and at most a partial link of their compensation to the firms' profitability. This gives them incentives to divert funds in various ways away from those who sink equity capital in the firm. Lower profitability and dividends, poor investment allocation and low productivity may be the result of failure to address these "corporate governance" problems. Institutional investors, because of their greater bargaining power over the firm relative to individuals, are well placed to minimise these problems.

Classens and Yurtoglu (2013) aver that the objective of a good corporate governance framework would be to maximize the contribution of firms to the overall economy—that is, including all stakeholders. Under this definition, corporate governance would include the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment.

Zalewaska (2014) contends that there has been a dramatic change in corporate governance practices over the past two decades as a result of the proliferation of the big corporate scandals since 1980. She goes on to observe that the agency problem has been exacerbated. Asymmetric information is at the heart of agency problems and is commonly thought to lie behind the market failures and the associated corporate scandals. But is asymmetric information more of an issue in the modern business environment than before? There are reasons to think that this may be so. First, the emergence of large scale businesses with complex organisational forms may have significantly increased opaqueness within corporations, resulting in greater informational

asymmetry between investors and management. Second, paradoxically, the asymmetry may have also increased as a result of informational technological progress. This is because, while on one hand, more information is now available, it may also cause information overload, hence, it may be more, rather than less difficult to extract information that is relevant and important. Third, it also seems that longer-run changes in ownership structure may have contributed to this change. The unprecedented growth of stock markets with the associated spread of ownership is thought to have decreased the ability of shareholders to monitor management. It also seems that the transformation of ownership from individual shareholders to institutional investors has not mitigated this problem (Zalewska, 2014).

Corporate governance practices have evolved over the years in South Africa. According to Ntim, Lindop and Thomas (2013) formal attempts at enhancing corporate governance practices in SA corporations began in 1994 with the King I report, but whilst the proposals were observably similar to those of other Anglo-American countries, the report distinctively focused on both financial (shareholder) and non-financial (stakeholder) aspects, particularly regarding the environment, health, safety and affirmative action. They go on to observe that, however, and crucially, King I failed to explicitly make recommendations relating to sound corporate risk management and reporting practices (King Committee, 1994, 2002). Consequently, King I was revised and replaced with a second King Report (King II) in 2002. Similar to King I, King II focused on governing the firm in the broader interests of both shareholders and stakeholders, but distinct from King I, it placed special emphasis on the need for sound and robust risk management and reporting practices (King Committee, 2002). Specifically, it provided explicit guidance in three main areas of risk management: definition, identification, and classification of risks; risk governance structure; and application and risk reporting. The promulgation of the new Companies Act in 2008 and changes in international corporate governance trends necessitated the revision of the code and hence the birth of King III in 2009.

King III extended the scope of reporting of companies to also cover:

- how a company has, both positively and negatively, impacted on the economic life of the community in which it operated during the year under review; and
- how the company intends to enhance those positive aspects and eradicate or ameliorate the negative aspects in the year ahead.

4 The regulatory framework of the South African insurance sector

The South African insurance sector (both long-term and short-term) is regulated by the Financial Services Board (FSB). Principally the Short Term Insurance Act of 1998 (STIA), the Long-Term Insurance Act of 1998 (LTIA) the Insurance Laws Amendment Act of 2008 and the Companies Act of 2008 govern the transaction of insurance business in South Africa.

The thrust in insurance regulation has been to enhance the solvency margins of insurance companies through prudential (financial soundness) regulations and to foster market conduct. A raft of reforms has been implemented and include amongst others, the Solvency Assessment Management (SAM) regime whose main aim is to improve the capital and solvency levels of insurance companies. This is risk based solvency assessment management that comes into operation in 2016.

Market conduct regulation is geared towards policyholder protection. Under this category, Treating Customers Fairly (TCF) regulations have been enacted. These are similar to those developed in the UK. Further the Financial Advisory and Intermediary Services (FAIS) Act promulgated in 2002 makes it mandatory for any person providing financial advice to have passed the regulatory examination and hence deemed “Fit and Proper” to proffer financial advice.

The Registrar of Short-Term and Long-Term insurance in South Africa has developed guidelines on governance and risk management for insurers which take effect from April 2015. These guidelines largely encapsulate the provisions of the King III code.

5 Internal corporate governance measures

As a yardstick to measure internal corporate governance practices we make use of the King III checklist and test the conformance of the insurance sector to this code. This code consists of nine broad areas with guidance given for each area.
These are:

(1) Ethical leadership and corporate citizenship
(2) Boards and directors
(3) Audit committees
(4) Governance of risk
(5) The governance of information technology
(6) Compliance with laws, rules, codes and standards
(7) Internal audit
(8) Governance stakeholders relationship
(9) Integrated reporting and disclosure.

Our sample consists of 9 insurance companies, three transacting short-term (non-life) insurance, three transacting long-term (life) insurance and the remainder being three composite (both non-life and life) insurance companies. These are as follows, (1) Short-term; Santam, Zurich and Renasa, (2) Long-Term; Sanlam, Lombard and Assupol, (3) Composites; Old Mutual, Clientele and RMI. We make use of Integrated Company Reports for 2013. The results are presented in the checklist below (Table 3).

Table 3. Results from the King III Checklist

King III Reference	Principle	Name of Company								
		Short-term Insurance			Long-term Insurance			Composites		
		Santam	Zurich	Renasa	Sanlam	Lombard	Assupol	Old Mutual	Clientele	Rand Merchant Insurance
CHAPTER 1. ETHICAL LEADERSHIP AND CORPORATE CITIZENSHIP										
1.1	The board should provide effective leadership based on an ethical foundation	A	A	A	A	A	A	A	A	A
1.2	The board should ensure that the company is and is seen to be a responsible corporate citizen	A	A	A	A	A	A	A	A	A
CHAPTER 2. BOARDS AND DIRECTORS										
2.1	The board should act as the focal point for and the custodian of corporate governance	A	A	A	A	A	A	A	A	A
2.2	The board should appreciate that strategy, risk, performance and sustainability are inseparable	A	A	A	A	A	A	A	A	A
2.14	The board and its directors should act in the best interest of the company	A	A	A	A	A	A	A	A	A
2.15	The board should consider business rescue proceedings or other turnaround mechanism as soon as the company is financially distressed as defined in the Act.	NA	NA	NA	NA	NA	NA	NA	NA	NA
2.16	The board should elect a chairman of the board who is an independent non-executive director. The CEO of the company should not also fulfil the role of the chairman of the board.	A	A	A	A	A	A	A	A	NA
2.17	The board should appoint the Chief executive officer and establish a framework for the delegation of authority.	A	A	A	A	A	A	A	A	A
2.18	The board should compromise a balance of power, with a majority of non-executive directors. The majority of non-executive directors should be independent.	A	A	A	A	A	A	A	A	PA
2.19	Directors should be appointed through a formal process.	A	A	A	A	A	A	A	A	A
2.20	The induction of an on-going training and development of directors should be conducted through formal processes.	A	A	A	A	A	A	A	A	A
2.21	The board should be assisted by a competent, suitably qualified and experienced company secretary.	A	A	A	A	A	A	A	A	A
2.22	The evaluation of the board, it committees and the individual directors should be performed every year.	A	A	A	A	A	A	A	A	A
2.26	Companies should disclose the remuneration of each individual director and certain senior executives	A	PA	A	A	A	A	A	A	PA
2.27	Shareholders should approve the company's remuneration policy	A	A	A	A	A	A	A	A	A

Table 3. Results from the King III Checklist (continued)

King III Reference	Principle	Name of Company								
		Short-term Insurance			Long-term Insurance			Composites		
		Santam	Zurich	Renasa	Sanlam	Lombard	Assupol	Old Mutual	Clientele	Rand Merchant Insurance
CHAPTER 3. AUDIT COMMITTEES										
3.1	The board should ensure that the company has an effective and independent audit committee	A	A	A	A	A	A	A	A	A
3.2	Audit committee members should be suitably skilled and experienced independent non-executive directors	A	A	A	A	A	A	A	A	A
3.3	The audit committee should be chaired by an independent non-executive director.	A	A	A	A	A	A	A	A	A
3.4	The audit committee should oversee integrated reporting.	A	A	A	A	A	A	A	A	A
3.5	The audit committee should ensure that a combined assurance model is applied to provide a coordinated approach to all assurance activities.	A	A	A	A	A	A	A	A	A
3.6	The audit committee should satisfy itself of the expertise, resources and experience of the company's finance function.	A	A	A	A	A	A	A	A	A
3.7	The audit committee should be responsible for overseeing of internal audit.	A	A	A	A	A	A	A	A	A
3.8	The audit committee should be an integral component of the risk management process	A	A	A	A	A	A	A	A	A
3.9	The audit committee is responsible for recommending the appointment of the external auditor and overseeing the external audit process.	A	A	A	A	A	A	A	A	A
3.10	The audit committee should report to the board and shareholders on how it has discharged its duties.	A	A	A	A	A	A	A	A	A
CHAPTER 4. GOVERNANCE OF RISK										
4.1	The board should be responsible for the governance of risk	A	A	A	A	A	A	A	A	A
4.2	The board should determine the level of risk tolerance	A	A	A	A	A	A	A	A	A
4.3	The risk committee or audit committee should assist the board in caring out its risk responsibilities	A	A	A	A	A	A	A	A	A
4.4	The board should delegate to management the responsibility to design, implement and monitor the risk management plan.	A	A	A	A	A	A	A	A	A
4.5	The board should ensure that risk assessment are performed on a continual basis	A	A	A	A	A	A	A	A	A
4.6	The board should ensure that frameworks and methodologies	A	A	A	A	A	A	A	A	A
4.8	The board should ensure continual risk monitoring by management	A	A	A	A	A	A	A	A	A
4.9	The board should receive assurance regarding the effectiveness of the risk management process	A	A	A	A	A	A	A	A	A

Table 3. Results from the King III Checklist (continued)

King III Reference	Principle	Name of Company								
		Short-term Insurance			Long-term Insurance			Composites		
		Santam	Zurich	Renasa	Sanlam	Lombard	Assupol	Old Mutual	Clientele	Rand Merchant Insurance
4.10	The board should ensure that there are processes in place enabling complete, timely, relevant, accurate and accessible risk disclosure to stakeholders.	A	A	A	A	A	A	A	A	A
CHAPTER 5. THE GOVERNANCE OF INFORMATION TECHNOLOGY										
5.1	The board should be responsible for information technology (IT) governance.	A	A	A	A	A	A	A	A	A
5.2	IT should be aligned with the performance and sustainability objectives of the company.	A	A	A	A	A	A	A	A	A
5.3	The board should delegate to management the responsibility for the implementation of an IT governance framework.	A	A	A	A	A	A	A	A	A
5.4	The board should monitor and evaluate significant IT investments and expenditure	A	A	A	A	A	A	A	A	A
5.5	IT should form an integral part of the company's risk management.	A	A	A	A	A	A	A	A	A
5.6	The board should ensure that information assets are managed effectively.	A	A	A	A	A	A	A	A	A
5.7	A risk committee and audit committee should assist the board in carrying IT responsibility.	A	A	A	A	A	A	A	A	A
CHAPTER 6. COMPLIANCE WITH LAWS, RULES, CODES AND STANDARDS										
6.1	The board should ensure that the company complies with applicable laws and considers adherence to non-binding rules, codes and standards.	A	A	A	A	A	A	A	A	A
6.2	The board and each individual director should have a working understanding of the effects of the applicable laws, rules, codes and standards on the company and its business.	A	A	A	A	A	A	A	A	A
6.3	Applied risk should form an integral part of the company's risk management process.	A	A	A	A	A	A	A	A	A
6.4	The board should delegate to management the implementation of an effective compliance framework and processes.	A	A	A	A	A	A	A	A	A
CHAPTER 7. INTERNAL AUDIT										
7.1	The board should ensure that there is an effective risk based internal audit.	A	A	A	A	A	A	A	A	A
7.2	Internal audit should follow a risk based approach to its plan.	A	A	A	A	A	A	A	A	A
7.3	Internal audit should provide a written assessment of the company's system of internal controls and risk management	A	A	A	A	A	A	A	A	A

Table 3. Results from the King III Checklist (continued)

King III Reference	Principle	Name of Company								
		Short-term Insurance			Long-term Insurance			Composites		
		Santam	Zurich	Renasa	Sanlam	Lombard	Assupol	Old Mutual	Clientele	Rand Merchant Insurance
7.4	The audit committee should be responsible for overseeing internal audit.	A	A	A	A	A	A	A	A	A
7.5	Internal audit should be strategically positioned to achieve its objectives.	A	A	A	A	A	A	A	A	A
CHAPTER 8. GOVERNANCE STAKEHOLDERS RELATIONSHIP										
8.1	The board should appreciate that stakeholders' perceptions affect a company's reputation.	A	A	A	A	A	A	A	A	A
8.2	The board should delegate to management to proactively deal with stakeholders relationships.	A	A	A	A	A	A	A	A	A
8.3	The board should strive to achieve the appropriate balance between its various stakeholder groupings, in the best interests of the company.	A	A	A	A	A	A	A	A	A
8.4	Companies should ensure the equitable treatment of shareholders	A	A	A	A	A	A	A	A	A
8.5	Transparent and effective communication with stakeholders is essential for building and maintaining their trust and confidence.	A	A	A	A	A	A	A	A	A
8.6	The board should ensure that disputes are resolved as effectively, efficiently and expeditious as possible	A	A	A	A	A	A	A	A	A
CHAPTER 9. INTEGRATED REPORTING AND DISCLOSURE										
9.1	The board should ensure the integrity of the company's integrated report.	A	A	A	A	A	A	A	A	A
9.2	Sustainability reporting and disclosure should be integrated with the company's financial reporting.	A	A	A	A	A	A	A	A	A
9.3	Sustainability reporting and disclosure should be independently assured.	A	A	A	A	A	A	A	A	A

A = Applied, PA=Partially Applied and NA=Not Applied

Source: Authors compilation (various company reports, 2013)

The premise of disclosure under King III is that, the company must comply and if it fails to comply with the code disclose why this has been the case. The results of the checklist show that the by and large insurance companies in South Africa are complying with the King III code of corporate governance. The sample under survey has not applied principle 2.15 which relates to turnaround strategies should the company be under distress, suffice to say that none of them have encountered financial distress.

The other component that the two companies in the sample under consideration failed to comply with is principle 2.26, which relates to the disclosure of the remuneration of directors and top executives. Their reasons for non-disclosure were that, either they feared for the safety of individuals whose remuneration is disclosed as being top earners or that they felt the disclosure was adequate when aggregated as the whole remuneration of directors.

6 Conclusion

The South African insurance sector has embraced the changes in corporate governance practices brought about by the King III code to strengthen their internal corporate governance practices. Further a plethora of regulatory reforms have been developed to secure the insurance sector and the market players are by and large conforming to these. However we wish to caution the regulators to strike the balance between the need for regulation and the "cost of regulation". Over-regulating the sector might end up stifling innovation in the sector and the ultimate cost of regulation might end up being borne by the insuring public in the form of higher premiums.

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