

**Risk Management, Corporate Governance and Accounting  
Practices and Financial Sector Stability – Perspectives on the  
Caribbean Insurance Industry.”**

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### **Abstract**

Over the last decade, the Caribbean insurance market has been interpreting and adopting many of the leading standards long-associated with the world’s more highly regulated insurance markets. There are many factors fueling this reform movement, some emerging, others long-standing. The recent developments in the international financial markets have raised serious questions about the effectiveness and efficiency of risk management and governance in financial services. Additionally, the global spotlight on the pending Solvency II regulatory reform, and the failure of a major financial conglomerate, has all accelerated the movement in the region. It is abundantly clear that independent and pre-emptive enterprise based risk management must be reinforced at every level – individual companies, regulatory bodies, governments, and rating agencies. Effective governance creates the context for managing risk and the enhancement of capabilities of managing risk; ERM augments Board oversight, clarifies roles and responsibilities and defines authorities and boundaries. Regulatory bodies globally have launched initiatives to bolster financial sector stability and restore market confidence –The prevalent regulatory themes being emphasized regionally are improved corporate governance (Board oversight) and risk controls within the industry, enhanced valuation and risk-based methodologies supported by the adoption of International Financial Reporting Standards and coordinated supervisory frameworks across the region, aligned with international best practice, to help ensure the future financial stability in the region. There are however emerging concerns being voiced by the indigenous Caribbean insurance industry. In particular, concerns are being expressed about the adoption of stringent micro-prudential regulation aligned to developed countries and which pay little cognizance to the limitations of the small open economies with underdeveloped capital markets as well as the reality that several regulatory initiatives are mirrored in both the banking and insurance sectors which may not appropriately distinguish between the business models of these two sectors. Indeed the simple transposition of rules across different institutional frameworks and sectors may lead to unintended consequences for the substantially indigenous Caribbean Insurance sector – as such a macro-prudential approach that considers not only the effects of systemic shocks over financial stability but also the effects of different regulatory strategies on macroeconomic stability should be encouraged.

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The underlying causes of the global financial crisis have been well documented. Poor underwriting standards led to excessive risk taking facilitated by failures in risk management, weak corporate governance and a lax regulatory environment. Globalization and complex financial products such as collateralized debt obligations and credit default swaps led to contagion and the onslaught of a global economic recession. What began as a US phenomenon quickly spread around the globe, even affecting us in the Caribbean.

As global markets return to some semblance of stability, the long-term effects of the crisis are yet to be determined. The IMF estimates global banking system losses, from the onset of the crisis through 2010, to total \$2.3 trillion (IMF, April 2010). Following multiple rounds of bailouts sovereign debt levels remain elevated. The IMF projects that public debt in advanced economies will exceed 100% of GDP in 2014 (IMF, April 2010).

A review of the events that have unfolded since the summer of 2007 indicate that corporate governance structures failed to safeguard organizations against excessive risk taking activities; accounting standards such as the use of mark-to-market accounting for illiquid financial instruments and the impairment model for loans and debt securities exacerbated the financial stress in the markets; while risk management systems failed to communicate effectively to boards of directors the risks facing organizations. At the microeconomic or market environment level, managements of financial institutions and boards faced challenging competitive conditions but also an accommodating regulatory environment. With competition strong and non-financial companies enjoying access to other sources of finance for their, in any case, reduced needs, margins in traditional banking were compressed forcing banks to develop new sources of revenue.

## **Enterprise Risk Management and Corporate Governance**

While there are a number of important lessons learned from the recent crisis, a few key themes emerge. The first is that an enterprise risk management framework, coupled with a robust governance structure is critical in promoting financial stability.

The Committee of Sponsoring Organizations of the Treadway Commission defines Enterprise Risk Management as “... a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives” (COSO, 2004). To put it simply, an ERM framework is a structured, consistent and continuous approach for identifying, analyzing, responding to, and monitoring risks and opportunities, within the internal and external environment facing an organization.

Traditionally, risks within an organization have been managed on a silo or risk by risk basis with the most popular form of risk management being insurance (Norlida Abdul Manab, Isahak Kassim and Mohd Rasid Hussin, 2008). Institutions separated risks into broad categories such as market, credit, liquidity, operational, regulatory, strategic risks etc or across business lines and management measured and managed those risks individually. However ERM “views risk as being more complete, consistent, and collective rather than focusing only on hazard or financial risk” (Norlida Abdul Manab, Isahak Kassim and Mohd Rasid Hussin, 2008).

In a 2010 survey of 346 executives from around the world conducted by the Economist Intelligence Unit, more than half of respondents believed their firms were effective at aggregating risks on a firm-wide level while less than half of respondents were confident that they understood the interaction of risks across business lines (EIU, May 2010). However, recent global events have shown the importance of approaching risks from a portfolio level, both within an enterprise and on the macro-economic level. Indeed, the ideas of systemic risk and contagion both support an ERM approach.

Implementing an ERM framework can facilitate proactive risk management; facilitate and increase understanding of all the risks that the organization faces; facilitate the integration of the management and prioritization of risks into planning and operational activities; and enhance the effectiveness of risk management activities. This will allow management to make better business decisions through a focus on risk and return which in turn will enhance enterprise value and preserve its soundness and profitability over time.

For an ERM framework to be effective it needs to be embedded throughout the organization. In 2008 a survey conducted by Towers Perrin less than half of the US respondents and only 52% of European respondents had a documented risk appetite statement in place (Towers Perrin, 2008). Since the crisis the awareness of the need for such a statement has increased. According to a 2010 EIU survey, 60% of respondents had a clearly defined risk management strategy in place which is updated regularly while 19% of respondents either don't have a risk management strategy or have one that is not updated regularly (EIU, May 2010). Indeed, it is when firms lack a clear, well defined strategy and move away from their stated risk appetite that they encounter problems.

One case in point is that of UBS AG. In April 2008, UBS issued a 50 page report to its shareholders outlining a number of risk management and corporate governance oversight failures that were responsible for the company reporting billions of dollars in write-downs on sub-prime investments. The report highlighted failures ranging from supervisory failures by senior management to incomplete and inadequate risk control methodologies (UBS, 2008). However, the magnitude of the losses incurred by UBS was a result of a lack of operational/notional limits and a disconnect between the risk appetite of certain business units and the organization as a whole.

UBS's stated group strategy was to focus on its integrated business model and grow its three global core businesses of (1) wealth management (2) asset management and (3) investment banking (UBS, 2008). However, the company admitted that its investment banking group focused on the maximisation of revenue without regard to the risk/reward trade-off.

The experience of UBS brings into the spotlight the relationship of corporate governance and financial stability. As part of the Regulatory pursuit of more consistent standards in the regulation and supervision of the insurance industry, including in Caribbean countries, one consistent theme is emerging– the fundamental need for improved risk management oversight and improved corporate governance (Board oversight) and risk controls within the industry. Also being emphasized is the need for enhanced valuation and risk-based methodologies and coordinated regional supervisory frameworks aligned with international best practice, with the stated purpose of assuring future financial stability in the region.

Vance (1983) opined that corporate governance ensures that long-term strategic objectives and plans are established; proper management structure (organizations, systems and people) is in place to achieve those objectives, while making sure the structure functions to maintain the corporation integrity, reputation and responsibility to its various constituencies. Clearly the experience two and a half decades later suggests that little attention was being paid to governance.

In a report on corporate governance lessons learned from the crisis (OECD, 2009), the OECD noted that poor corporate governance was responsible for failures in risk management such as a lack of communication of risks to the board and managing risk on an activity rather than enterprise level. The OECD also highlighted that the recent push for independent directors led to weakening of board oversight in some instances. The report further makes the point that for an organization to have a strong corporate governance structure it is not sufficient just to have independence and objectivity. Board members need the requisite industry skill and expertise in order to govern effectively. However, in the small Caribbean space, this is of particular concern given the limited availability of qualified professionals willing or able to sit on corporate boards.

Regulatory proposals and amendments are at various stages of development however it is clear that independent and pre-emptive enterprise based risk management must be developed and reinforced at every level – individual companies, regulatory bodies, governments, and rating agencies.

Effective governance creates the context for managing risk and the enhancement of capabilities of managing risk; while an enterprise approach to Risk Management augments Board oversight, clarifies roles and responsibilities and defines authorities and boundaries.

At issue however is the perception of some Caribbean insurers that this approach is for the large and sophisticated; indeed a common sentiment, albeit tacitly and quietly expressed by owner/managers in the Insurance sectors is that these concepts run counter to pragmatism, entrepreneurialism and organisational simplicity. On one hand, it is comforting that this is recognised by the Regulators – According to Dr. Marion Williams, Governor of the Central Bank of Barbados “We must ensure governance does not become a science which is caught up, not in functionality, but in complexity – and that the impression is not given that the greater the complexity, the more laudable and thorough is the oversight.” However, equally instructive is the commentary of Finance Minister and former Central bank Governor of Trinidad & Tobago Winston Dookeran, speaking on the CL Financial bailout, during his inaugural Budget Speech on 8<sup>th</sup> September 2010 – “This fiasco was caused by reckless corporate governance and the glaring failure of our financial regulatory institutions. This crisis was caused by an absence of risk management, excessive borrowing internally and externally to fund high risk speculative investments, and wrong financial reporting...”

### **The Issue of International Accounting Standards**

The era of globalization has no doubt spawned an increasing complexity that challenges directors; with increased thresholds of financial innovation, the bottom line result has been higher risks. The accounting profession has had to review traditional models of governance and to compose new ones. It is commonly accepted that the adoption of International Financial Reporting Standards (IFRS) has strengthened financial systems by supporting stronger regulation and supervision as well as provide for greater transparency.

However, the issue of fair value accounting and in particular the emphasis of the substance over form of transactions raised questions internationally as to whether it represented an accurate assessment of value in stressed or illiquid markets as opposed to simply amplifying inefficiencies and fuelling investor panic. The recent global financial crisis has exposed specific accounting weaknesses principally in ensuring the reliability of financial statements, transparency, provisioning adequacy and portfolio valuation.

As a result of the crisis, a key issue has been raised: Does fair-value or mark-to-market accounting represent an accurate assessment of value in stressed or illiquid markets or does it merely amplify inefficiencies, and fuel investor panic. According to the EIU, 60% of respondents believe that mark-to-market accounting exacerbated the financial crisis (EIU, May 2010). Mark-to-market accounting seeks to establish a value for financial instruments based on market prices. Under current accounting rules, financial instruments are valued using current market prices (if a market exists), or current market prices of similar instruments (if there is a market) or by using modelled valuations if there are no similar instruments available (Matherat, 2008). Under current accounting standards, there is no set definition for what constitutes an active market and no guideline on when an institution can move from a valuation based on market prices to one based on a modelled price (Matherat, 2008).

Proponents argue that mark-to-market accounting merely reflected the effects of poor underwriting standards and excessive risk taking. The FASB notes that it is “especially critical that fair value information be available to capital providers and the other users of financial statements in periods of market turmoil accompanied by liquidity crunches.” Supporters of mark-to-market accounting go on to argue that if institutions aren’t forced to mark securities to market, investors could never be certain about asset value and would be reluctant to provide additional capital to troubled institutions. However, whether the banking sector write-downs due to the loss in value of financial instruments backed by subprime mortgages were as a result of actual default levels or were precipitated by accounting standards continues to be debated.



Mark-to-market accounting as a valuation process works well in normally functioning markets, however as the market becomes stressed and liquidity disappears, valuation becomes less reliable and moves further away from true market value. As a result, in the height of the crisis, assets such as mortgages, bonds and structured debts that were being serviced normally had to be re-valued as a result of frozen markets. This led to institutions being forced to rid themselves of those assets at fire sale prices which further led to lower market valuations and pushed corporations to the brink of insolvency. Thus the impact of mark-to-market accounting was to amplify market stress. Mark-to-market accounting essentially forces an institution to value its investments at the value it can receive today regardless of the company's investment horizon. Steve Forbes likens mark-to-market accounting to forcing a homeowner to value their house at a price it can be sold for in the next 24 hours (Forbes, 2010).

The Bank for International Settlements noted that "as liquidity evaporated quickly in the markets for many complex structured products and primary and secondary transaction prices became unavailable, some banks responded by switching from valuation methods based on observable prices (or indices) to methods that relied more on modelled valuations." (BIS, 2008)

The BIS went on to state that "In some cases, products were valued on the basis of their price at the time of origination or based on trading prices for similar transactions. In other cases, valuations were determined by using generic credit spreads based on the product's assigned rating. Moreover, some banks assumed that primary market prices were good indicators of secondary market value or liquidity. When primary markets dried up, banks with no contingency arrangements in place were left exposed and for them the valuation of secondary market products became a serious problem." (BIS, 2008)

Apart from valuation issues, mark-to-market accounting could even facilitate risky behaviour. In benign markets, unless crystallized, fair value accounting actually recognizes gains before they are earned which leads to inflated profits and equity which in turn promotes overleveraging of the balance sheet.

Thus, when the market is in stress and companies are forced to recognize fair value losses, the increased leverage results in massive write downs and the risk of a catastrophic loss. Apart from the technical challenges, there remain unresolved commercial challenges in determining how to assess business strategies given the recent volatile market consistent results including the implications for asset liability management and new business pricing for Life insurers. This debate rages on for the international insurance industry, reconciling IFRS, particularly as it relates to valuation on a market consistent basis with the emerging Solvency 2 standards and GAAP accounting.

As yet, little progress has been made in defining international accounting standards for insurers, and global insurance industry is compelled to work with a standard that rarely reflects its true economics. When the International Accounting Standards Board (IASB) issued standard IFRS 4 in 2004, the measurement of insurance liabilities was avoided simply through compliance with the regulatory accounting standards for individual jurisdictions. In parallel, European insurers have developed and implemented market-consistent embedded values (MCEV) as a complementary value-reporting framework. After over a decade of work on insurance standards, the IASB launched a new attempt to finalize insurance accounting with its Exposure Draft (ED) of new valuation and presentation standards in July 2010.

It is clearly understood that the degree of compliance with International Accounting Rules influences the way in which we are viewed internationally, primarily as reflected in the international ratings of corporations, regional banks and Insurers and country ratings. For the Caribbean Insurance industry, the unquestioning adoption of IFRS by the auditing firms and its acceptance in the new wave of Regulatory reforms begs the question of applicability to small and medium players. However, even for the larger companies given the undeveloped state of our capital markets there are significant challenges. The insufficient supply of issues and the tendency for institutional investors to purchase and hold issues to maturity in support of ALM, results in low levels of activity on secondary markets for the instruments, and present significant challenges to the construction of yield curves.

However, even in the case of apparently efficient markets, it may be necessary to ensure that there is sufficient depth and liquidity as there may be a risk of manipulation in a market with too few players or with too little depth. (Matherat 2008)

### **Regulatory Reforms and Financial Sector stability**

The most important issue impacting global financial stability is regulatory reform and the need for balanced and pragmatic approaches. In both the US and EU there has been a barrage of legislation aimed at reforming the financial services industry and preventing another meltdown. The recent passage of the financial reform act formally known as the Dodd-Frank Wall Street Reform and Consumer Protection Act is the US government's latest attempt to eliminate the failures that led to the crisis. The bill is designed to reign in risky behaviour of banks; eliminate the occurrence of institutions that are "too-big-to-fail" while it gives the regulators the ability to break-up large complex companies that may pose a systemic threat; provide shareholders with a say on executive compensations, end the prospect of future bailouts while enhancing consumer protections (Dodd-Frank, 2010).

During the 1990's, while several Caribbean economies approached the issue of financial market liberalization in response to structural reform programmes and started the process of upgrading their regulatory and supervisory frameworks, these were focused largely on the banking sector. The capital markets, insurance sectors and non-banking financial intermediaries were left untouched.

Over the last decade however, the Caribbean insurance market have embraced many of the leading standards long-associated with the world's more highly regulated insurance markets. In particular, the standards of the International Association of Insurance Supervisors ("IAIS") appear to be the basis on which The Caribbean Association of Insurance Regulators ("CAIR") and The Offshore Group of Insurance Supervisors ("OGIS") treat with domestic and international insurance supervision.

Locally, regulatory oversight of financial institutions has intensified significantly with an emphasis on corporate governance and the link with risk management. In response to our own systemic threat which stemmed from the failure of CL Financial, regulators have accelerated the comprehensive review of financial legislation. In Trinidad & Tobago, The Financial Institutions Act 2008 and the proposed Insurance Act seek to close regulatory gaps and strengthen the respective roles of Boards of Directors, external auditors and actuaries.

Although regulatory proposals and amendments throughout the Caribbean are at various stages of development and important details are still being negotiated, change is inevitable. While Jamaica was the first country in the region to conduct sweeping regulatory reforms (from 2000-2005), in recent years Trinidad and Tobago's regulatory regime has been emerging as the new leader in the reform movement. Given the pressures on IAIS member states to adopt the IAIS's core principles and methodology coupled with lessons learned from recent corporate failures, most of the regions' regulators are increasingly sensitive to the cost of complacency and the urgent need for a more harmonized Caribbean regulatory framework. Also of significance, regions hosting off-shore financial industries are acting quickly to achieve mutual recognition and supervisory equivalence with key international jurisdictions in order to retain offshore business. (Braitwaite & Bauman 2010)

Caribbean regulators will become much more focused on working on the formulation and application of regional standards which are aligned with international best practices. Supporting the harmonization of regional Supervisory frameworks will be the pursuit and achievement of convergence in the areas of Corporate Governance, Group-based supervision, Risk measurement, consistency in the valuation of insurance liabilities, and Risk-based solvency standards. However, a closer look at financial institution failures across the globe and particularly within the region reveals the common underlying factors of overleveraging and companies straying from their core business model.

In the US, the traditional banking model of accepting deposits, granting mortgages and securitising credit risk off the balance sheet operated efficiently for decades. Insurers such as AIG got into difficulty when it expanded its core insurance model to include credit default swaps. In the Caribbean, the failure of CL Financial resulted from the group's involvement in non-core business activities which were left exposed by the global economic recession. In this regard, another emerging concern being voiced by the indigenous Caribbean insurance industry. In particular, concerns are being expressed about the fact that several regulatory initiatives are mirrored in both the banking and insurance sectors which may not appropriately distinguish between the business models of these two sectors. Indeed, the argument of the insurance industry is that the simple transposition of rules across different institutional frameworks and sectors may lead to unintended consequences for the substantially indigenous Caribbean Insurance sector.

The core activity of insurers is risk pooling and risk transformation, while that of banks is the collection of deposits and the issuing of loans, together with the provision of a variety of fee-based services. At micro-prudential level, insurance companies typically have access to stable, up-front and long-term funding, a simpler balance-sheet structure and a lower exposure to liquidity risk. The ownership and transparency of risks assumed are similar in insurance and conventional retail or corporate banking, but are lower in some non-core banking activities. The interconnectivity between institutions is a core part of the banking business model (in particular due to interbank lending), whereas in insurance it is very low. On average, capital volatility is higher in banking. The investment approach in insurance is more long-term and driven by more predictable liability than the more short-term and asset-driven approach in banking. (CEA 2010)

As a consequence, the risk profiles of insurance companies and banks differ fundamentally. The core of the insurance business model is the diversification of risk in the portfolio and over time. This determines insurers' long-term risk profile, in contrast to the more short-term risk profile of banks. Insurance companies are mainly exposed to underwriting and market risk and relatively benign liquidity and credit default risk.

Banks are largely exposed to liquidity, market and credit default risk but have no exposure to insurance underwriting risk. Market risk is significant in both banking and insurance, but fundamentally different in its components, including a lower asset liability mismatch risk in insurance. While both Banks and Insurers are financial intermediaries the roles and processes differ as it supports the efficient functioning of the whole economy. Banks provide leverage to the economy and are part of the payment and settlement system. As such, banks transmit to the economy the monetary policy of central banks. Insurers, on the other hand, make an important contribution to economic growth by providing consumers and businesses with protection against negative event; function is however much less directly connected respect to the whole economy. (CEA 2010)

At macro-prudential level, based on the criteria for the identification of systemic risks drawn up by the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS), the core insurance business model does not generate systemic risk that is directly transmitted to the economy. There is far lower contagion risk, higher substitutability and lower financial vulnerability than in banking. While there is no doubt that regulatory gaps played a significant role in facilitating the risky behaviour that caused the crisis, proposed regulatory reforms should focus on restricting companies from venturing into businesses where they lack the experience and expertise as well as preventing risky behaviour. It is being suggested that the convergence of regulatory reforms more appropriate to banking industry would be the wrong regulatory response to problems that in insurance are either non-existent or small. Additionally, regulatory exuberance in the context of capital markets maturity is of great concern in developing economies.

According to Dr. Marion Williams, “as we attempt to anticipate every eventuality in the new era of corporate governance, we must not over-regulate as some have argued happened in the case of Sarbanes Oxley in the aftermath of Enron and WorldCom. This is particularly a concern in fledgling capital markets, or we will not afford these markets the opportunity to flourish as was afforded to North America and Europe 50 years ago when regulations did not stifle them

and when they were at the stage that we are in the Caribbean right now. We need to increase our vigilance and improve our oversight – but we also need to strike a balance.” It is in this context that the Insurance Industry is suggesting a macro-prudential approach that considers not only the effects of systemic shocks over financial stability but also the effects of different regulatory strategies on macroeconomic stability.

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