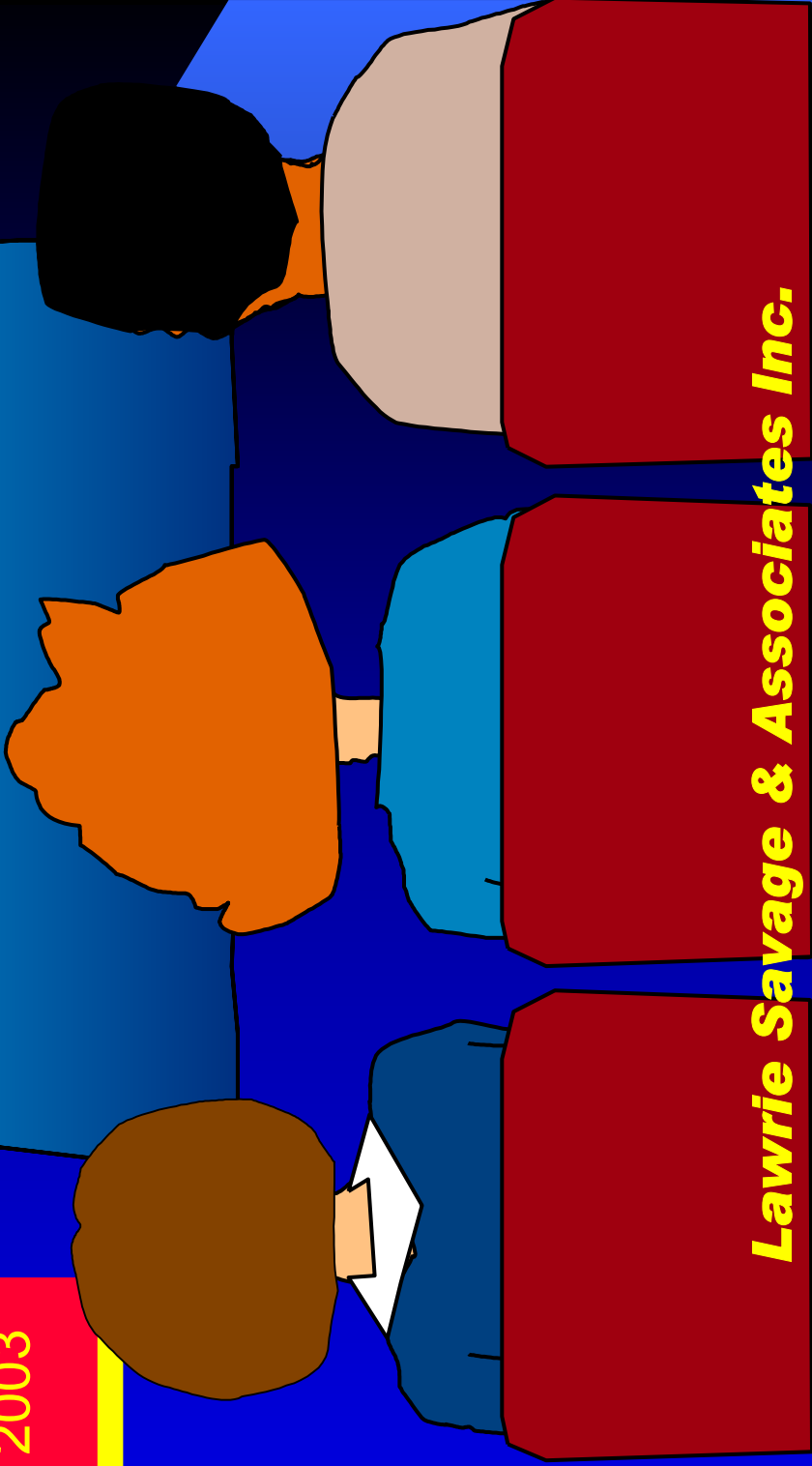


**Conference on
Contractual
Savings**

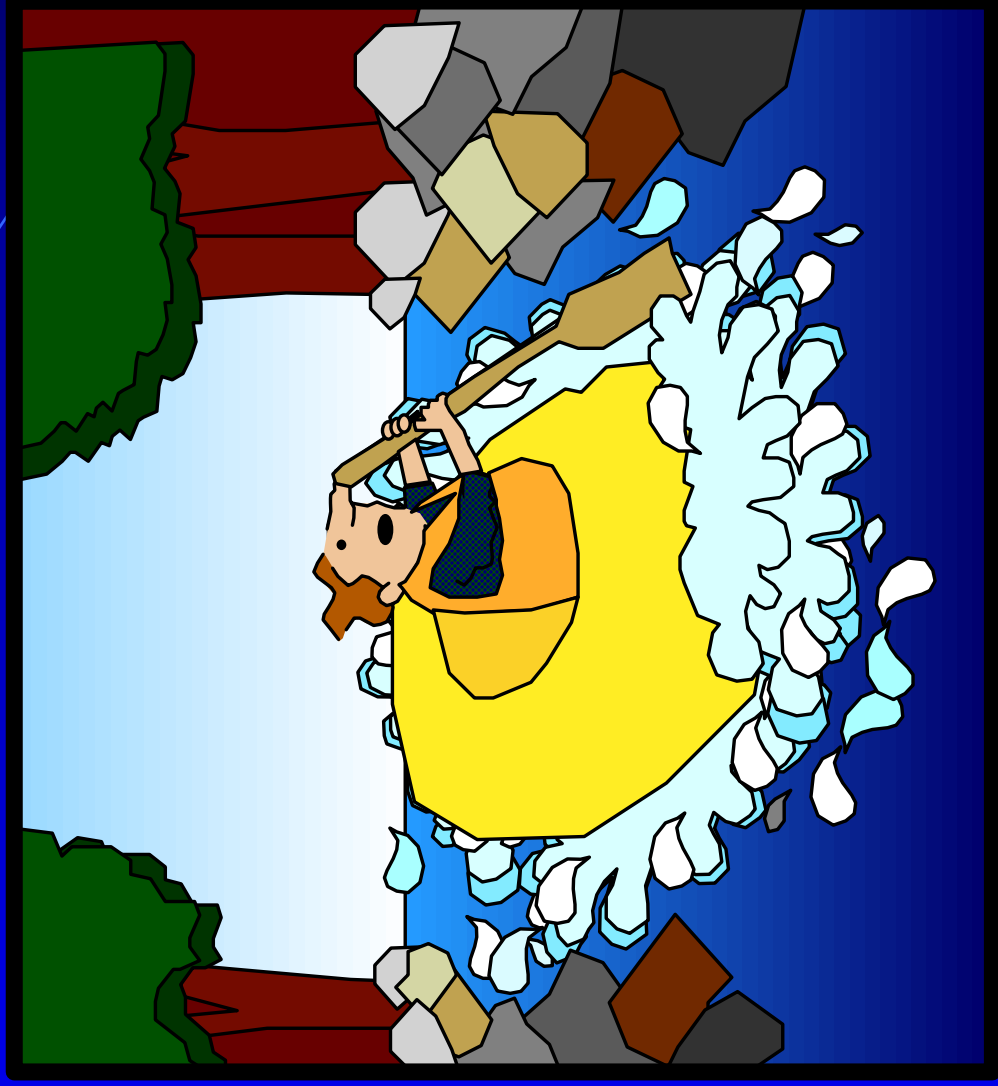
**The World Bank
Washington D.C.
November 2003**

**Corporate Governance
and Financial
Institutions**



Lawrie Savage & Associates Inc.

The Canadian Experience



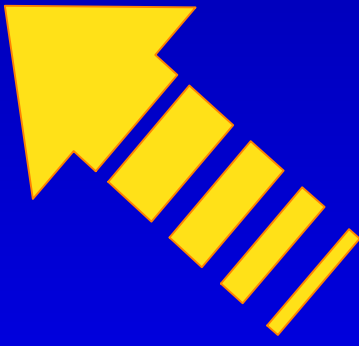
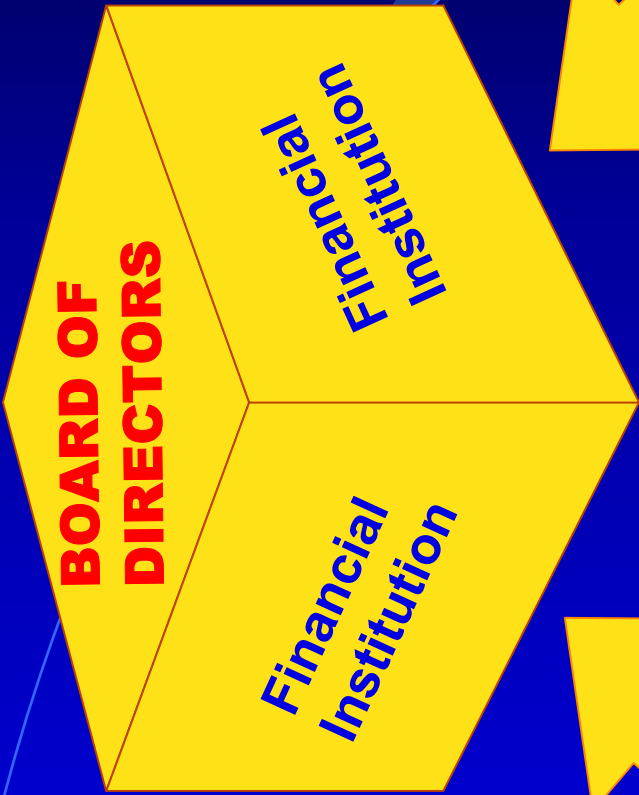
The Canadian Experience

- Many years with no insolvencies
- Late 1970's, 1980's: higher inflation, volatile interest rates
- ~ 18 insolvencies between 1980 and 1993!
- Solution: More resources for the supervisor OR a different approach?
- Realization: In fundamental sense, financial supervision could not have prevented the failures. Something else was needed . . .

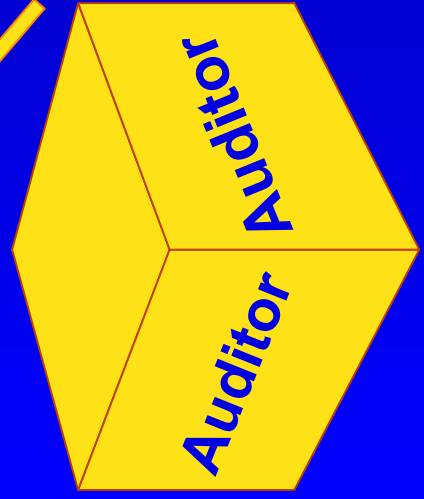
Corporate Governance

1. Internal policies and procedures intended to ensure that the company is operated in accordance with sound business and financial practices.
2. The fiduciary responsibilities of financial institutions suggest that especially high standards of corporate governance will be expected.
3. The quality of the institution's risk management is an important part of corporate governance.
4. The Insurance Act can establish overall goals and make boards of directors accountable.

Corporate Governance Framework



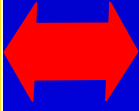
Financial Institution Act



Corporate Governance

Board

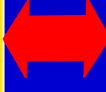
Responsible for managing, appointing
Statutory duty of care



Audit Committee

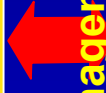


Majority of independent director members



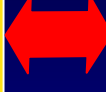
Auditor

Financial Reporting,
Well Being



Management

Input and advice in
all areas, Internal
Audit



Actuary

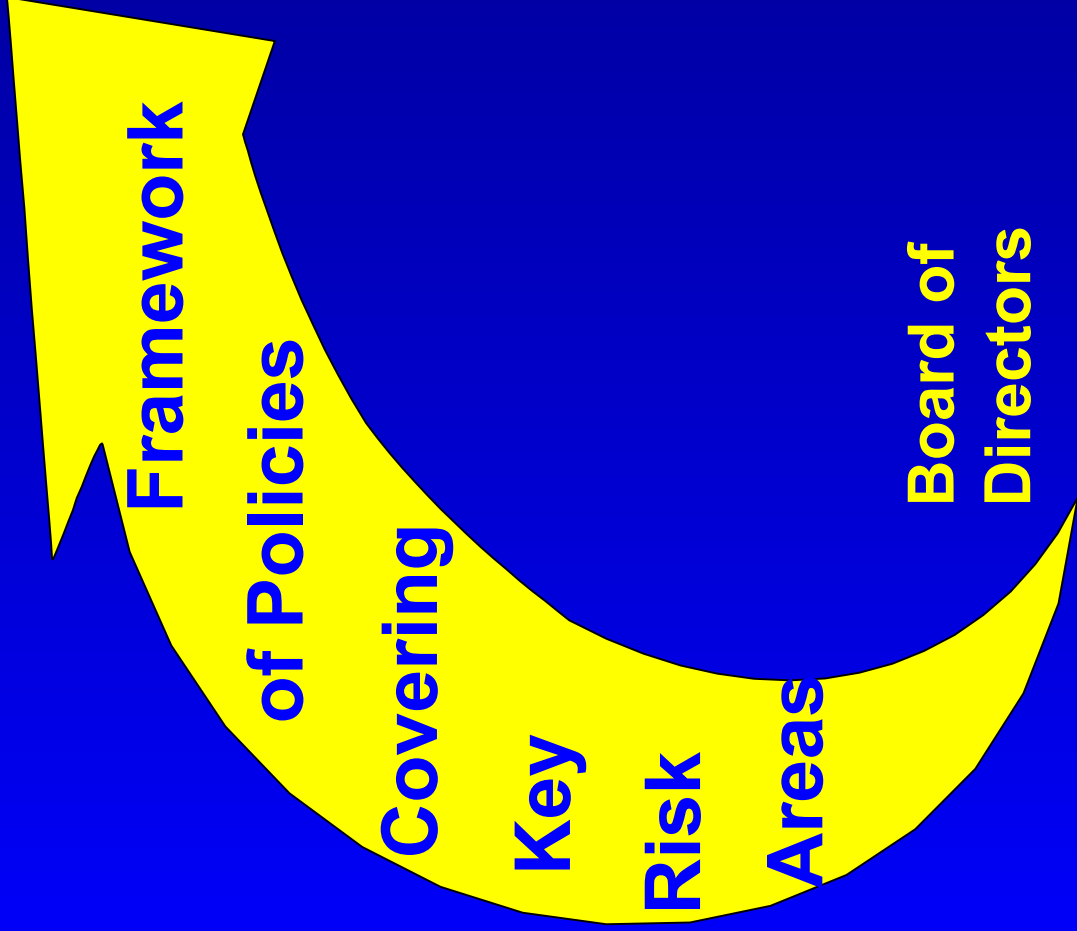
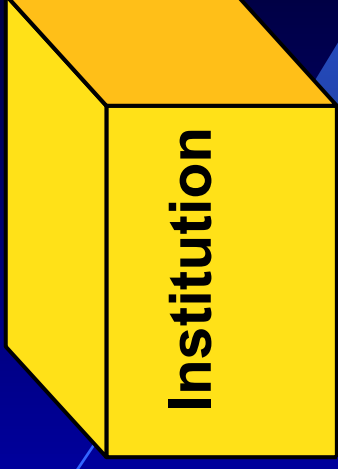
Valuation, Risk based
capital, Dynamic
Capital Adequacy
Testing or “stress
testing”

Corporate Governance

Board

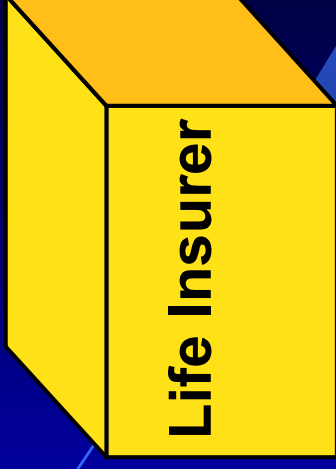
Note: "Independent" directors are directors who are not shareholders or employees of the FI or any related companies. They are appointed by the board in exactly the same way as other directors. There are no special requirements which they have to meet, other than being "fit and proper" .

Standards of Sound Business and Financial Practice



Board of
Directors

Standards of Sound Business and Financial Practice



Framework

of Policies

Covering

Key

Risk

Areas

**Board of
Directors**

1. product design and pricing risk
2. underwriting management risk
3. interest rate risk management
4. security portfolio management risk
5. credit risk management

6. foreign exchange risk management
7. real estate appraisal risk
8. liquidity risk management
9. capital management
10. internal control risk management

Evolution of Supervisory Approaches

**Old Style
Approach**

**Find contraventions of the law,
regardless of materiality ...**

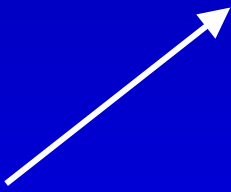
**Reconciliation of data, counting the
securities, other detailed checking ...**

Evolution of Supervisory Approaches

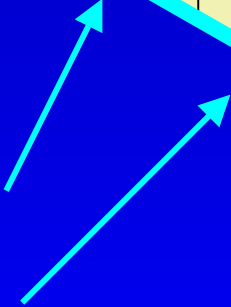
Risk Based Supervision

Business Strategy

Old Style Approach



Management style, attitude to risk, control environment, ...

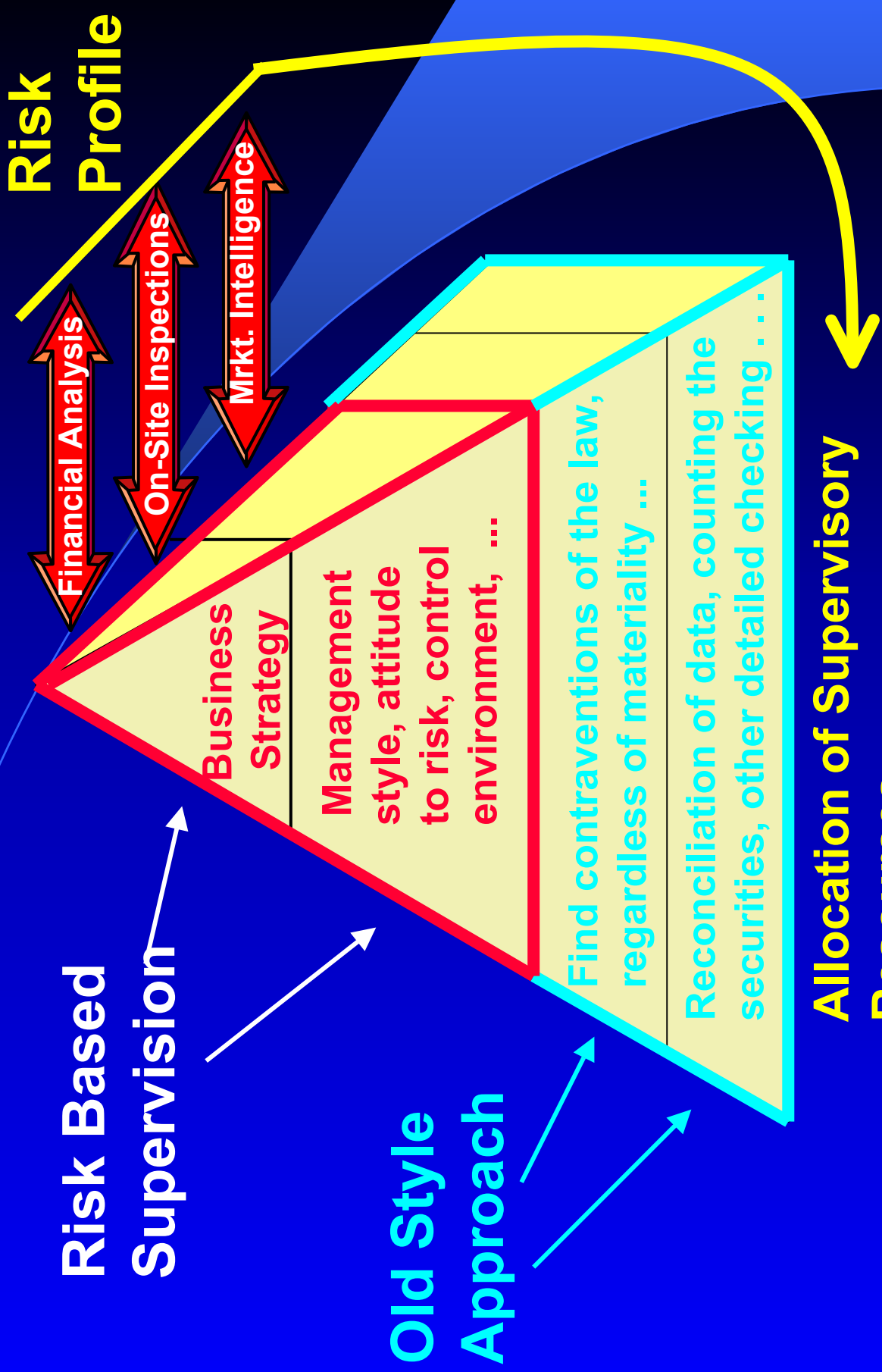


Find contraventions of the law, regardless of materiality ...

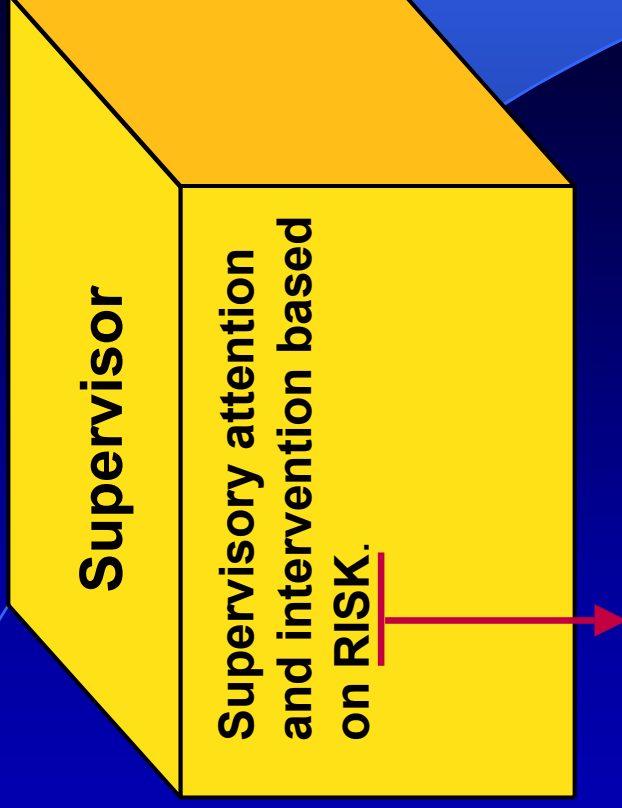
Reconciliation of data, counting the securities, other detailed checking ...

Today we are concerned with assessing the degree of risk in the company's business operations – and how to reduce risk as required

Evolution of Supervisory Approaches

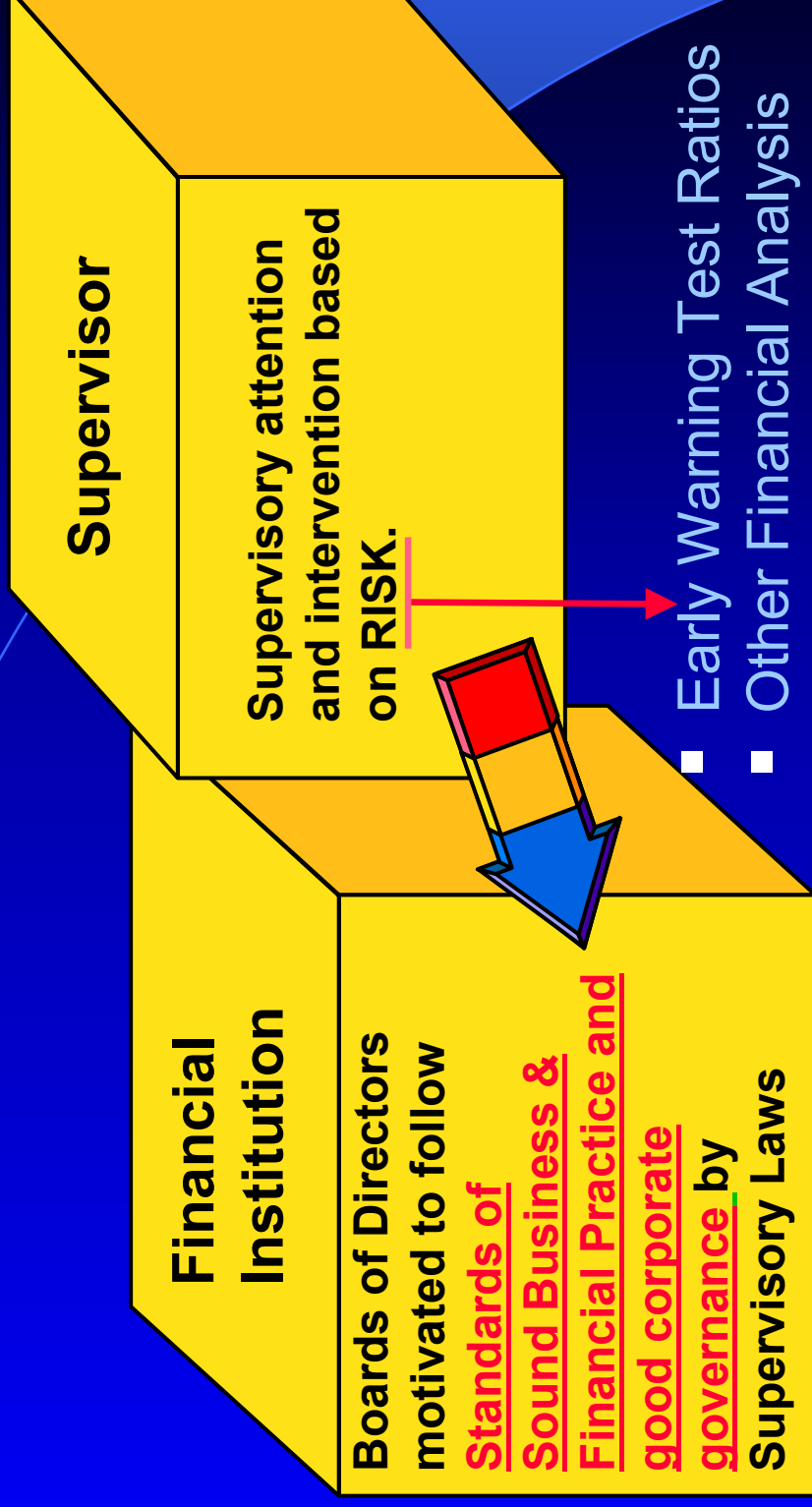


Risk Based Supervision

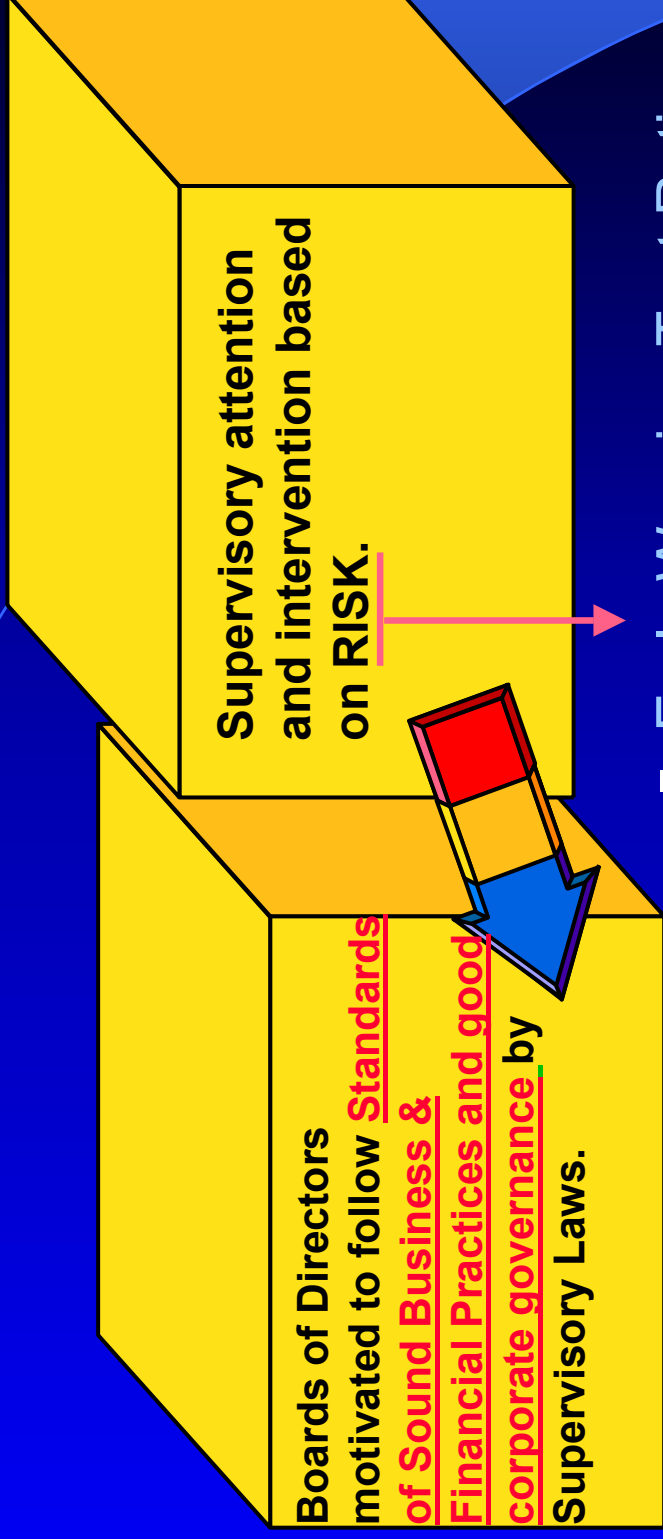


- Early Warning Test Ratios
- Other Financial Analysis
- On-Site Inspections
- Market Intelligence
- Self-Assessment with audits

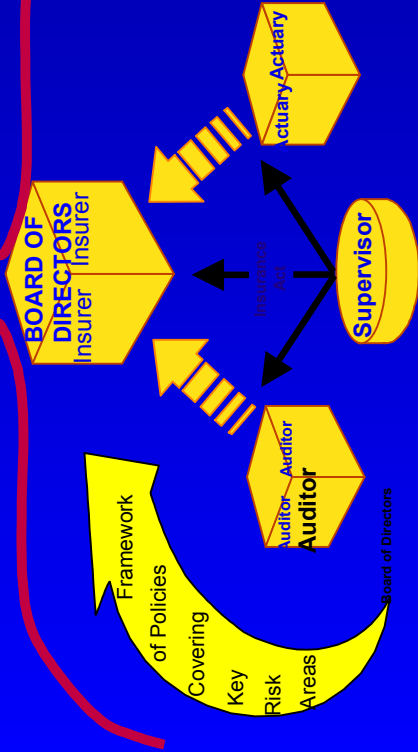
Risk Based Supervision



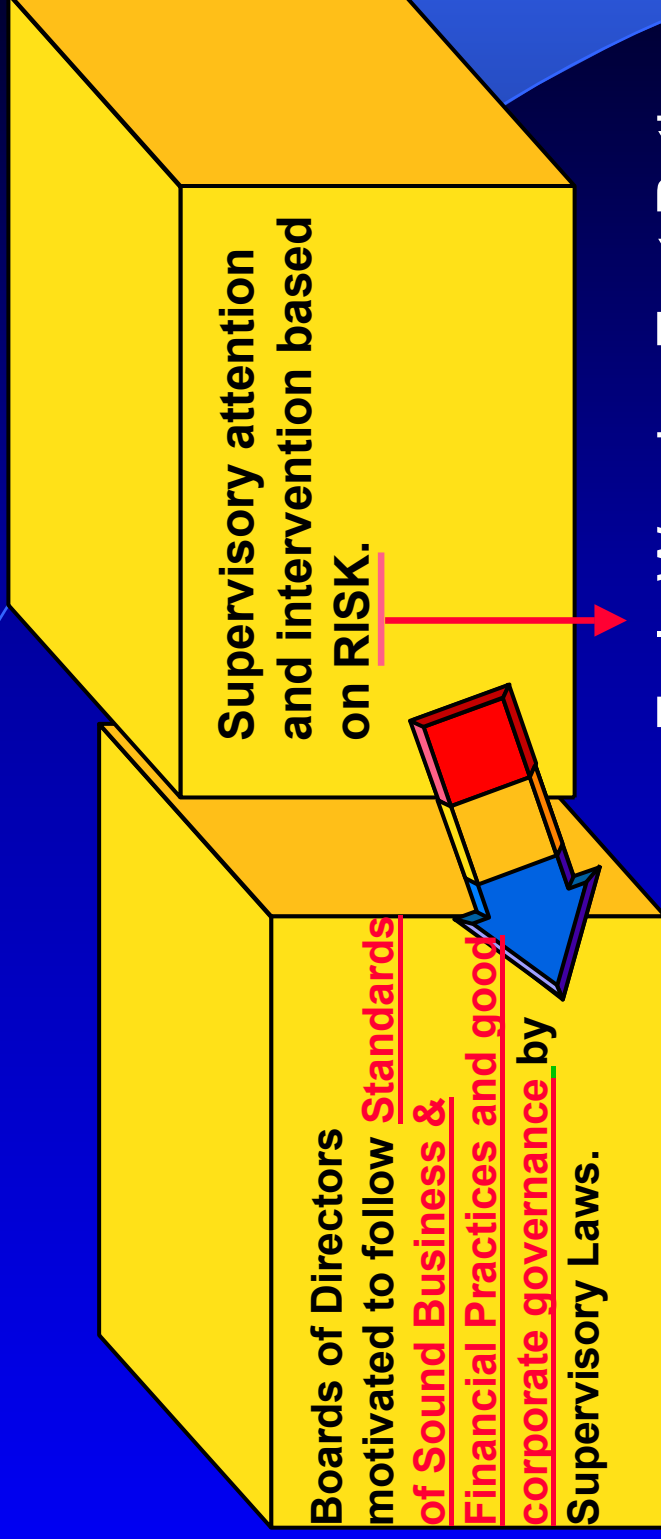
Risk Based Supervision



- Early Warning Test Ratios
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Risk Based Supervision



- Early Warning Test Ratios
- Other Financial Analysis
- On-Site Inspections
- Market Intelligence
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**Public and Investor
Confidence in
Financial Institutions**

International Association of Insurance Supervisors: Core Principles

- **ICP 9: “The corporate governance framework recognizes and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.”**
- **ICP 9 essential criteria include 11 responsibilities of the board of directors and 3 for senior management.**
- **While the new ICP’s are generally excellent, go further with best practices . . .**

IAIS Core Principles, continued

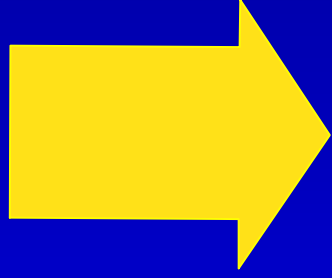
- **Composition of board to include independent directors**
- **Audit committee of board with specific responsibilities to meet with auditor re. financial controls, accounting issues etc. Same for actuary.**
- **Specific responsibilities to control related party investments – must meet specified criteria**
- **Written policies**
 - **for investments**
 - **risk management in claims, reinsurance, underwriting, product design**

Why is Corporate Governance Important to the Supervisor?

- **It is management and the board that are in a position to ensure that the company is well run, not the supervisor**
- **Financial institutions obtain public funds so company directors and senior managers have a responsibility to shareholders AND to the public;**
- **Governments don't have the resources, nor is it feasible, to try to check everything in a financial institution so there has to be reliance on the board and management**

Corporate Governance

Trend in Financial Supervision:



Declining emphasis on detailed rules to be enforced by the regulator

Increasing responsibility on board of directors to ensure institution follows "sound business and financial practices"

Sound Corporate Governance

Example of Corporate Governance

Insurance Act – Ontario Canada

- *Every insurer that authorizes one or more agents to act on behalf of the insurer shall establish and maintain a system that is reasonably designed to ensure that each agent complies with the Act and the regulations.*
- *The system referred to . . . must screen each agent for suitability to carry on business as an agent.*
- *An insurer shall report to the Superintendent if it has reasonable grounds to believe that an agent who acts on behalf of the insurer is not suitable to carry on business as an agent.*

Risk Management for the Supervisor

Zone of Unpredictability

Management error, natural disaster, rapid changes in economic conditions, ...



Additional risk predicted by fin'l monitoring, examination and market intelligence.

% of Risk Explained

Percent of total risk predicted by use of ratios.

5 10 15 20 25 30 35 40 45
Number of ratios in use

Risk Management for the Supervisor

Zone of Unpredictability

Corporate Governance, including support of auditors and actuaries.

Additional risk predicted by fin'l monitoring, examination and market intelligence.

Percent of total risk predicted by use of ratios.

% of Risk Explained

5 10 15 20 25 30 35 40 45

Number of ratios in use

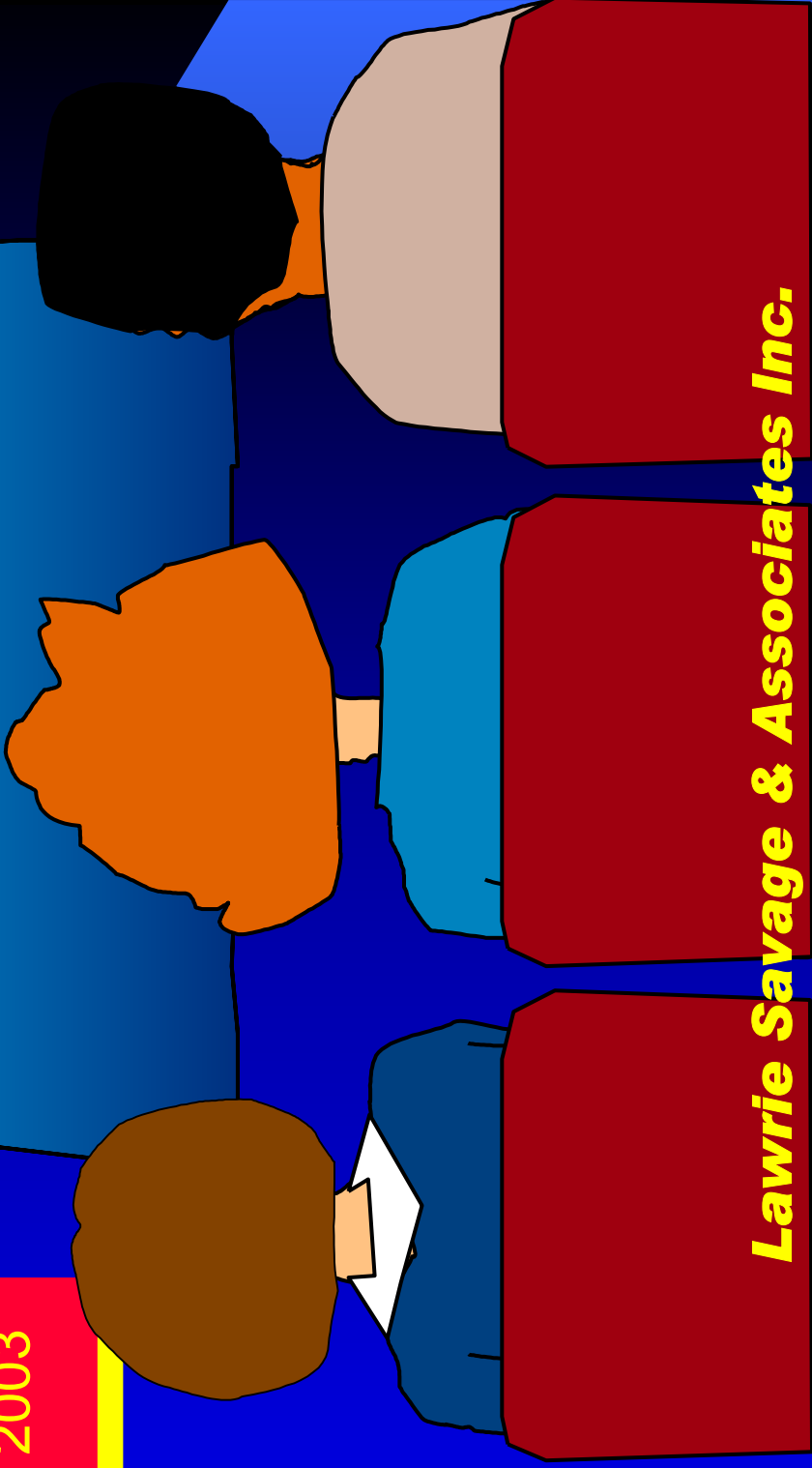
Corporate Governance in Canada 10 Years Later

- **No requirement for separate Board Chairman and CEO**
- **LS experience as corporate director: business as usual**
- **Recent examples show that many in the industry and the media haven't understood what is happening**
- **Conclusion: It will take more high profile cases before people begin to understand that it's a new world with a different paradigm.**

**Conference on
Contractual
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End of Presentation



Lawrie Savage & Associates Inc.