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Risk Intelligence: Increase Your Analysis of Applicants

Due Diligence and Suitability Criteria for Directors and Senior Leaders

Insurance companies face increasing regulatory requirements and scrutiny in their Corporate Governance, in particular the evaluation of the effective oversight of their Board of Directors. Boards of Directors have a higher standard of due diligence in the industry, including suitability of its directors, than ever before. Some leading practices for an insurance company Board are explored here.

What's Changed

While regulators have long-focused on the solvency of insurers, they are now interested in much more than the numbers. They now are assessing a company's structure of decision-making processes—and h*ow a company arrives at those numbers*. Even more, they will look at how an insurer's enterprise risk management framework helps ensure the company's *sustainability*.

Of particular importance is the **National Association of Insurance Commissioners (NAIC) Corporate Governance Annual Disclosure (CGAD) Model Act and Regulation**, which shines a spotlight on the make-up of a company's Board of Directors. A key requirement of the CGAD is to demonstrate that the Board, as a whole, possesses the core competencies needed to oversee all the key risk areas of the company, and the effectiveness of that oversight. Because of this new law, many companies are creating or updating corporate governance guidelines and suitability criteria for choosing new Board members. In addition, companies are taking a fresh look at their due diligence procedures within the search for new Directors, as well as officers and other senior leaders.

Compliance Requirements for Insurance Company Due Diligence

The **Violent Crime Control and Law Enforcement Act of 1994**, Public Law 103-322, H.R. 3355; Title 18, United States Code, Sections 1033-1034 (the Act), lays the basis to determine what kinds of background check

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compliance procedures should be implemented for all employees and Directors. This Act directs that anyone with a state or federal felony for breach of trust cannot work in the financial services industry, including in "the business of insurance." This means that before a person becomes a Board Director or is hired by the insurer, a full state and federal criminal background check is required, at a minimum.

Another source of important background information for due diligence is credit and financial history. Looking at a credit report and reviewing any outstanding tax liens, bankruptcies and other credit issues can provide a window into an individual's lifestyle, money-handling and overall financial responsibility. Written standards, against which you measure these reviews in your selection criteria, are crucial to ensure you treat all potential candidates fairly and equitably.

These financial insights can reveal important information when deciding on a new Director because of the accountability they will share for the future solvency of the company. Equally important is a demonstrated duty of care toward the company's assets as well as to your policyholders' assets—a fiduciary duty.

Included in a company's standards should be flexibility for exceptions, however. For instance, a bankruptcy resulting from medical bills should be considered in a different light than a bankruptcy for lifestyle debt. Likewise, a 58-year-old who discloses a felony conviction dating from when he or she was 18 may be justified in contacting the **Department of Insurance** for a waiver to allow them to work in the business of insurance, as is allowed in the Act.

Additionally, because the Act has no grandfathering for any felony for breach of trust, the company should consider one additional step beyond standard background and financial checks, which typically cover a certain time period such as five or seven years. This means all applicants for the Board or senior leadership must sign a statement on their application that they have never been convicted of a felony for breach of trust (e.g. misappropriation of funds or a breach of fiduciary duty).

In spite of the requirements of the Act to ensure that no felons convicted of breach of trust are allowed to work in the business of insurance, most insurance companies do not run background checks periodically on their senior leaders or Board members after the initial check.

For Directors and senior leaders, insurance companies typically limit their ongoing due diligence to an annual certification of key compliance requirements and that attestation becomes an important documentation of ongoing due diligence and compliance.

As an added precaution, consider having each member of the Board of Directors and all senior leaders certify to the following items each year, placing a statement similar to this confirmation at the top of the document:

"I attest to my compliance with these requirements with honesty and integrity, and to the best of my knowledge that:"

1. In the past 12 months, I have not been convicted of a felony for breach of trust, and there is no trial pending for felony breach of trust, and no charges are pending.
2. In the past 12 months, I have not been convicted of any criminal action, under state or federal law, and no charges are pending.
3. I have read, understood and have abided by [Company] Standards as communicated in [list sources, such as Code of Ethics and Business Conduct, Conflict of Interest statement, compliance training, H.R. training, etc.] for the past 12 months, and commit to abide by them in the future.

Suitability Criteria for Members of the Board of Directors and Senior Management

The most rigorous essentials apply to the selection process when seeking to fill senior leadership positions, the president or chief executive officer position, or empty seats on the Board of Directors. The CGAD models, in fact, very

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specifically address the requirements for Directors and Chair of the Board.

At the broadest level, Board Directors must have the appropriate background, experience, and integrity to fulfill their prospective roles in overseeing the company management. Examples of that expertise include appropriate education, experience, intelligence, independence, fairness, moral character, reasoning, and judgment for effective leadership.

Some of these terms may seem vague or overly discriminatory—for instance, what level of intelligence is demanded and how is that intelligence defined? While the CGAD lists these characteristics, each company and Board may want to turn these general qualities into more readily identifiable ones. "Intelligence" could be defined as "possessing a curious mindset, open to lifelong learning," for instance. "Education" does not necessarily require a certain level of schooling, but could be stated as "learned in the areas of expertise used during one or more credible careers."

The Board Committee charged with vetting candidates will also need to assure that the qualifications of a senior leader for the company or a prospective Board member include such attributes as integrity, accountability, informed judgment, financial literacy, mature confidence, and high performance standards.

An excellent way to validate the background of each Director, and continue to document overall Board level competency going forward, is to periodically update Director biographical affidavits and refile, as required, with state insurance departments.

The following list of qualities contains examples that might be included in an insurance company's selection criteria for Directors and senior management.

Any senior leadership or Board role

- Proven integrity
- A record of substantial achievement
- A high degree of leadership experience in a complex organization such as a corporation, financial services company, university, foundation, or governmental unit
- A reputation for sound business judgment
- Understanding of the oversight role of the Board and the management workings of the company in the current business and risk environment
- A reputation or record of working as part of a team in an environment of collegiality and trust

Suitability for Directors

- The ability to appraise management's plans, programs, achievements and shortcomings objectively, with independent thinking
- A capacity for asking difficult or challenging questions with a goal of leading to better outcomes for the entity
- The financial and subject matter expertise required to provide the necessary, effective oversight of a diversified and heavily regulated financial services or insurance business
- Willingness and ability to devote the necessary time to the work of the Board and its committees, including materials review and meeting attendance

CGAD requires that the Board as a whole possess a number of what regulators see as "core competencies" needed to oversee the insurance company. Examples of core competencies to consider are:

- accounting or financial proficiency
- sound business judgment
- broad insurance industry knowledge
- documented management success
- recognized leadership
- visionary and forward-thinking
- strategic intelligence

One way to ensure that the Board meets these criteria is to require at least one member of the Board to possess sufficient competence in at least one of these core areas. The Board Committee selecting new Directors will also need to assess a nominee's independence and evaluate whether the nominee's skills are complementary to the existing Directors' skills and Board and company needs. In addition, the Board Committee should consider diversity, cultural competence, experience, expertise and such other factors as it deems appropriate.

Suitability of the Board Chair

The objective criteria used to select the Chair from the pool of Directors might be expanded beyond other Director requirements to include such factors as:

- exemplary service on the Board
- demonstrated duty of care for the company
- proven executive leadership experience
- strong communication skills

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- ability to work well with senior leadership
- confidence to lead the Board with a "hands-on, fingers-off" oversight of the company

What Can Disqualify a Sitting Board Member?

Felonies: Reviewing a Director's annual certification with regard to felonies, Code of Ethics and Business Conduct violations, and Conflicts of Interest is an important step towards determining if a Board member has disqualified himself or herself from a position on the Board. Many companies use a broader definition of criminal convictions (not just felony or breach of trust), in which case any criminal conviction might be grounds for automatic termination from the Board.

Conflicts of Interest: When an existing Director takes on new employment with, ownership in, or membership on a Board of another financial services entity, insurance company, or other related or regulatory entity, that change can result in a conflict of interest. If a Director becomes an active insurance producer in any capacity or a staff member of any organization governed by the same regulatory body as is the insurance company, these dual roles are often considered conflicts of interest that would disqualify that Director.

Absenteeism: Documented requirements for Board membership should include attendance and commitment standards. Some consideration can be allowed for attendance via telephone conference call if a member is unable to attend a meeting in person. However, the requirements should set a standard of attendance, committee participation, and specific commitment to the work of the Board. A lack of commitment that demonstrates itself with non-attendance, non-review of materials prior to meetings, non-participation in Board training events, or lack of contribution to assigned committee work may all be reasons for disqualification.

The responsible Board Committee (such as a Corporate Governance Committee) should review all of the certifications and documentation with the Corporate Secretary and/or General Counsel and make recommendations regarding possible dismissal of a Director. The Board as a whole (excepting the Director under review) will review and vote on these recommendations.

Solvency and Sustainability

Consistent use of the types of background checks, financial checks and due diligence described above helps ensure that senior leaders and Board members meet legal and regulatory standards, as well as providing a springboard for company standards. These expectations will establish legal, cultural, ethical and moral standards, as well as emphasizing the protection of consumers and the company as high priorities.

How can the company predict its own sustainability? When these key concepts are thoroughly integrated:

a. The transparent purposes and goals of the insurer serve all its stakeholders well;

b. High levels of accountability and integrity are expected from its stakeholders;

c. Management functions effectively within the risks and opportunities of the current and future business environment, and;

d. The Board oversees management of enterprise risk with skill and vision.

Summary

Increased regulatory scrutiny in the insurance industry calls for increased internal scrutiny. To help position and solidify your company as a risk-minded culture with high standards of integrity, consider steady, consistent improvement in monitoring your human capital. Every person who represents your company should be informed about, understand, and accept the necessity and appropriateness of these controls.

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