Meeting Challenges and Exceeding Expectation in Mutual Corporate Governance.

NAMIC CORPORATE GOVERNANCE WHITE PAPER EXCERPT

Board Committees

Companies of all sizes utilize a board committee structure to help accomplish their governance responsibilities. The advantages of a committee structure are apparent – committees can apply more extensive experience and abilities (for example, financial or planning expertise) or more focused attention (for example, director recruitment, governance, investments) to significant areas of activity.

Some of the factors that help to decide whether a board should establish a committee include:

- The specific skill or experience required to understand the activity or issue and to propose recommendations or make decisions.

- The time commitment required to oversee the particular issue or activity.

- The importance of the issue or activity that is the subject of the committee's responsibilities.

Mutual companies and other corporations are not required by state incorporation acts to have any specific committees. 1 Among NAMIC members surveyed however, the following committees were identified (in order of most common first): investment committee, executive committee, compensation committee, and audit committee. The fifth most common committee is a nominating committee – one that is frequently mentioned as an important corporate governance function. (See the following sections for a more detailed review of these common mutual company board committees.)

All board committees are responsible to the board and need to keep the board informed of their activities. Agendas are usually worked out by the committee chairman in cooperation or consultation with the chairman of the board. The CEO may also be involved in committee meeting agenda setting if the chairman of the board is a separate position.

Increasingly, companies are providing each board committee with written charters that clearly identify and define their responsibilities. 2 A well written charter addresses such matters as the purpose of the committee, the specific functions and tasks assigned to the

committee, the delegated authority of the committee (decision-making or recommendations only), and meeting and reporting time frames. Committee charters serve as helpful orientation material for new board and committee members. They are also helpful when a board or committee evaluation is conducted.

To utilize a board committee structure effectively, selection of qualified committee members must become an important board governance priority. Appointments should be made only after thoughtful review, including a consideration of the qualifications of the board member for the committee's specific tasks (a committee charter can help here too). As an example, the board may expect or require audit/financial committee members to be financially literate.3 Companies may even expect or prefer that at least some members of a financial/audit committee, the chairman of the committee for instance, have actual experience in financial matters (perhaps even insurance financial or accounting experience).4 In a similar manner, the board may decide that a compensation committee's effort can be enhanced if at least some of the members, or the chair, are knowledgeable or have actual experience in, the human resources area.

In addition to any specific knowledge or experience requirements, it is important for the chairman of any committee to have good organizational and leadership skills. These skills include the ability to create an agenda, conduct a meeting, facilitate discussion among committee members, and present committee reports to the full board in an effective manner.

The size of any particular committee is generally a function of its responsibilities, the nature of the subject matter, and its importance. As with any working group, a balance must be struck between the efficiency of a small group and the benefits of a larger group, including the variety of perspectives, more capacity for work, and greater knowledge or experience.

Boards will also want to ensure that each committee has the resources needed to perform their function adequately. In some cases this may include the support of management staff in gathering information or helping prepare reports. In other cases it may be the authority to hire outside expertise (legal, financial, etc.) to assist the committee in their responsibilities.

Finally, it can be a good practice to periodically review or evaluate the overall committee structure of the board to consider the following issues:

Committee Purpose:

- Is special knowledge or effort still required for this issue/activity?
- Can the work of any committees be combined?
- Should the work of the committee be expanded?

Committee responsibilities (as established by written charter):

- Is the authority granted consistent with the responsibilities delegated?
- Are the specific functions and tasks still relevant?

Committee size:

- Does size impact positively the level of discussion/review we desire?
- Does size allow the level of representation or expertise we desire?

Committee structure:

- Should the Chairperson have special expertise?
- Should an officer of the board serve on the committee?

Mutual companies have formed a number of committees for the benefit of in-depth review of key company activities and operations. The following descriptions apply to the most common committees that mutual company boards use to meet their oversight responsibilities.

Audit committee

Financial information and management practices are critical to any business organization since all companies must fairly and accurately report and utilize financial information. It is particularly important however, to insurance organizations because of the financial regulatory oversight they receive and the significance of sound financial practices to the service they provide their policyholders.

*Management is responsible for the financial reporting process and internal control of the Company. The independent auditors are responsible for auditing and publicly attesting to the fairness of the Company's financial statements and, in connection therewith, evaluating the Company's system of internal control for the purpose of determining the nature, timing, and extent of their auditing procedures. The audit committee is responsible for overseeing the… participants in the financial reporting process and for reporting to the board of directors, which ultimately is responsible for the oversight of corporate performance … "*1

The financial literacy of members of a company's financial/audit committee has become increasingly important to boards. Committee members are expected to be able to read and understand insurance company financial statements as well as important financial ratios and terms. 2 The chairman of the committee is often expected to be knowledgeable and experienced in financial management, perhaps with a specific insurance accounting or financial management background.3

The specific tasks or functions of the audit committee are well established and generally include the following:

- Recommend or select the firm that is to serve as independent auditor for the current year and review the estimated fee (some recommend that the audit committee actually have the authority to hire/fire the audit firm);

- Review and discuss the audit plan with the auditor and understand the critical accounting policies, judgments and estimates being applied;

- Meet regularly with internal auditors and review the qualifications, independence, and work product of the auditor;

- Review with the auditors their proposed audit report and management letter, if any;

- Meet privately with the independent auditor from time to time to review the adequacy of management's internal controls and recommend corrective action as needed;

- Review with management and independent auditor the quarterly and annual financial statements of
the company before such statements are filed with the appropriate insurance and other regulatory authorities or otherwise published, specifically inquiring as to the existence and resolution of any disagreements between management and the auditors with respect to such statements.4

Audit committees are increasingly being asked to understand and review the business risks that the company is subject to and to oversee the risk assessment and risk management activity of staff as part of their responsibilities. 5 As a result, access to both outside expert resources and internal staff is important to assure good audit committee performance. In cases where companies lack the resources for a dedicated internal audit function, the role of the committee may also expand into this area and require access to outside resources. Boards will want to make clear to the audit committee their authority regarding access to such resources.

The audit committee is also one of three committees where the presence of independent directors has been identified as important.6 Not surprisingly, highly regulated industries have the highest proportion of independent directors on their audit committees.7 Boards will want to carefully consider the independence of the committee chairperson, since an inside director (and especially the CEO) faces the potential for clear conflicts as a result of the committee's audit responsibilities and role.

Nominations/Governance Committee

A nominating committee is generally tasked with finding, qualifying and recommending nominees for election to the board and/or its committees. This is a significant

responsibility, and an increasingly time consuming one because of the rising demand for good directors. Recruiting quality directors appears to be especially important to the financial services industry. It is one of only five industries where the majority of companies in the industry have standing nominating/governance committees.1

Some nominating committees have a broader scope of responsibilities than simply nominating board members. These expanded responsibilities often include overseeing the company's corporate governance practices since *" ... if good governance oversight is vital – it makes sense to form a board level committee that focuses specifically on how well the board and management is handling this crucial duty."* 2

The responsibilities of an expanded "nominating/governance" committee often includes matters of board structure, board committees and committee operations, board governance policies (ethics/conduct, conflicts, etc.), and board evaluations. Factors that a mutual board will want to take into account in the decision to create a nominating/governance committee include:

- The importance attached to recruiting qualified board members in the future.

- The importance and advantages of a regular review of the company's governance practices.

- The relative need for a change in governance.

- The desire to create a focus on change and a process for overseeing corporate governance improvement activity.

The last point listed above is worth additional explanation. The creation of a nomination/governance committee (or expansion of the nominating committee's duties) can be an important first step for boards that believe their governance practices can and should be improved. Such an improvement effort may require a concentration of time, effort and resources that a committee structure is well equipped to provide to the board on important matters.

General responsibilities for an expanded nominations/governance committee could include:

- Establish criteria for board nominations and committee appointments.

- Recommend nominations for the board.

- Recommend committee appointments.

- Oversee policyholder governance relations and any policyholder participation issues and activity.

- Oversee the board-meeting process, including information reporting and meeting management performance.

- Develop governance principles, policies or guidelines for adoption by the board (conduct, ethics, etc.).

- Oversee board and/or board member evaluations.

Membership on the committee does not generally require any special background or expertise. Some governance advocates suggest that only independent directors serve on the committee to reinforce the idea that this committee is not unduly influenced by management and controlled exclusively by the board. Whatever decision is reached about the independence of its membership, the committee will need to work closely with the CEO in the discharge of its responsibilities.3

Compensation Committee

Financial service companies generally do not use compensation committees (sometimes referred to as *personnel committees*) as much as companies in other industries. 1 Since management compensation is both important and increasingly scrutinized, however, the justifications for a compensation committee seem more compelling than ever. For some companies the responsibilities of a compensation committee can be included as part of another committee's charter (e.g., the executive committee). The need to attend to compensation issues are the same regardless of the committee structure of the board.

Compensation committee responsibilities often include the compensation and benefits plans of the entire company, not just the senior management. The functions or tasks typically assigned to compensation committees include:

- Oversight of the company's overall compensation/benefits program.

- Setting the compensation/benefits of the CEO (or senior management).

- Ensuring linkage between compensation and long-term goals.

- Conducting or managing the process of the CEO's evaluation.

Compensation committees benefit from members, or the chairman, having knowledge or experience in compensation/benefits or human resources. The committee can also benefit from access to internal human resources department staff or outside compensation/ benefit experts. This is particularly helpful in mutual organizations where compensation plans must often be more creative to align management's interest to that of the company or its policyholder-members.

Here again, governance advocates recommend that only independent directors serve as members of the compensation committee. This reinforces the idea that the committee is

not controlled or unduly influenced by management. Advocates also contend that an independent committee helps insulate the board from any inherent conflict where inside directors serve on the committee that oversees the CEO's compensation and/or evaluation. However, many companies choose to have the CEO as a part of this committee because of the CEO's knowledge of company information, staff and operations. All of these areas impact, and are impacted by, compensation committee decisions.2

Executive Committee

After investment committees, executive committees are the most common board committees among NAMIC mutual member companies surveyed. Executive committees fulfill a number of functions, including conducting the CEO evaluation/performance review (as an alternative to the compensation committee), initial development or review of important policies for the full board to consider and approve, and/or initial review or formulation of long-range plans.

The executive committee also serves as an emergency decision-making body on behalf of the board where expediency does not allow for a full board meeting. Executive committees generally possess the authority of the full board, unless the issue under consideration is a fundamental company matter (merger, sale of substantial assets, director dismissal, etc.). For some companies the executive committee has become unnecessary due to the presence of other more specialized committees or because the full board has been restructured to a more manageable size.

Investment Committee

According to the 2002 NAMIC governance survey, an investment committee is the most common board committee among mutual companies surveyed. The presence of this committee in so many company governance structures demonstrates and reinforces the importance of good financial management for mutual insurance companies.

Boards are ultimately accountable for the investment function of the mutual company. Often however, the board does not have the required skill, experience, or time to manage or oversee a portfolio of any size. Delegating the task to a single person is also unwise, since the responsibility is often too great for a single person to handle. A committee composed of knowledgeable and competent directors is a reasonable approach to this important function.

Generally, the committee is responsible to:

- Establish and maintain investment policies and guidelines for investments.
- Determine and monitor asset allocation for investments.
- Set expectations for diversification and security selection and asset performance.

- Monitor returns and review asset performance.

- Approve any investment transactions that exceed management limits of authority.

- Interview, hire and review any investment managers that may be needed.

- Review the overall effectiveness and appropriateness of the investment policies and management practices and recommend any changes.

- Report to the board on all of the above.

Footnotes

Board Committees

1. This contrasts with the requirements of publicly traded stock companies that may be under a legal or self-regulatory obligation to have an audit committee. The chief sources for such obligations come from the listing exchanges or the SEC (note more recently the attention to audit committees for publicly traded companies in the context of the Sarbanes-Oxley legislation).
2. Carter McNamara, "How Should the Board be Structured?", http://www.boardmember.com/network/index.pl?section=1086&article_id=10359&show, boardmember.com (Board Governance/General Governance).
3. Financial literacy is a subject that is addressed elsewhere in this paper in "Board Qualifications".
4. Interestingly, a majority of public company directors recently surveyed believes the higher requirements being imposed on audit committee members by recent listing rules or legislation are "unfair". 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p11.

Finacial/Audit Committee

1. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p2. Audit committees were important to boards even before recent listing and other regulatory requirements regarding their existence and the requirements of membership. 99 percent of the over 5,000 US public companies tracked by the NACD have an audit committee. Audit committees are recognized and agreed to be one of the most important committees by 98 percent of public company directors surveyed recently (along with a compensation committee). 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p20.
2. There are a number of sources for a definition of financial literacy. One of the better sources is found in the Report of the NACD Blue Ribbon Commission on Director

Professionalism, 2001 Edition, National Association of Corporate Directors, (Washington, D.C. 2001), Appendix C. Another source is the comparison chart compiled by Holly J. Gregory, Comparison of Corporate Governance Guidelines and Codes of Best Practices: United States , Weil, Gotschal & Manges, LLF (New York, 2000).

3. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p30.
4. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p37.
5. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p13.
6. Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors (Washington, D.C. 2001) p5.
7. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p21.

Nominations/Governance Committee

1. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p25.
2. Myron M. Sheinfeld, "The Corporate Governance Committee", Corporate Board Nov/Dec 2000, volume 21, issue 125, p1.
3. "The survey responses indicate directors' clear preference for a nominating process that is driven by an independent nominating committee with input from the CEO". 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p29.

Compensation Committee

1. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p23.
2. Insiders still serve on a number of public company compensation committees – only 61 percent of compensation committees are composed of all independent outside directors. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p23.