

Corporate Governance and Ownership Structure of Property-Liability Insurers¹

By Enya He, David W. Sommer, and L. Lee Colquitt

Introduction

The topic of corporate governance has generated extensive research in the academic world as well as much heated debate among politicians, regulators, the media and the general public. The series of corporate and accounting scandals of the past decade, including Enron, Tyco International, Adelphia and Worldcom, brought renewed attention to corporate governance, and the recent financial crisis has greatly intensified such research and debate. Despite such extensive research and discussions, a number of "misguided beliefs" about corporate governance remain among academics, politicians and the media, according to a recent study by Brickley and Zimmerman, two leading researchers in the field.² One particular misguided belief pinpointed by the authors is the common practice by academics, consultants or regulators to "unconditionally classify a particular governance practice as 'good' vs. 'bad,' or 'weak' vs. 'strong.'" For example, firms with certain characteristics of boards of directors (i.e., more independent boards, smaller boards, etc.) are often identified as having good/strong governance practice. This type of belief has contributed to such uniform requirements on board structure as those imposed by the NYSE and NASDAQ and by the Sarbanes-Oxley Act (SOX) in 2002. Yet, often ignored by regulators, practitioners and academics alike is the interdependence among different elements of the corporate governance system.

In this study, we explore the interdependence of firm ownership and board structure in the United States property-liability insurance industry. What we find is that boards of property-liability insurance firms generally appear to be structured in a very systematic manner that appears consistent with firm value maximization. This has significant implications. For example, it implies that external regulations imposing uniform rules on how insurers structure their boards may be counterproductive. In addition, the results of the study may be of use to insurers in making decisions regarding the structures of their own boards, or to regulators, consumers or other outsiders who are evaluating the appropriateness of an insurer's board structure.

An Overview of Corporate Governance

In many business organizations, the people who own the organization are distinct from the people who manage the daily affairs of the organization. In other words, a separation exists between the ownership of the organization and the control of the organization. This creates potential incentive conflicts, with managers acting in their own interests rather than in the interests of the owners. Rather than seeking to maximize the value of the firm for its owners, managers may pursue activities with the goal of maximizing their power and the amount of assets under their control. They may engage in excessive perquisite consumption and build lavish office buildings for themselves. They may behave in an excessively risk-

ABSTRACT

A separation exists between the ownership and control of most firms, and this separation creates potential incentive conflicts, with managers acting in their own interests rather than in the interests of the owners (resulting in what is referred to as "agency costs"). There are varying degrees of this separation, depending upon the organizational form and ownership structure of the firm. An effective way in which to monitor management's behavior and to reduce agency costs is with outside board members, those members who are not themselves in management positions with the company. An analysis of approximately 1,130 property-liability insurers over nine years suggests that insurers use varying degrees of participation from outside directors, depending upon the firm's ownership structure, to effectively monitor management behavior. Results show that the greatest use of outside board members is found with ownership structures that have the greatest need for monitoring management. In addition, those structures with the least separation of ownership and control employ the fewest outside board members.

averse fashion, to minimize the chance that they will lose their jobs rather than maximize owner wealth. Or, they may simply not work as hard as they would if they were the owners of the firm, and enjoy more leisure time. All of these incentive conflicts are potential consequences of the separation of ownership and control. The structures, systems and processes designed to control these incentive conflicts are generally described under the heading of corporate governance.

A variety of internal and external corporate governance mechanisms exist in modern business organizations. Externally, the hostile takeover market serves as a check on managerial behavior; if managers fail to maximize the potential of a firm, outsiders may buy the firm and replace the existing managers with new ones. Internally, corporate governance schemes include executive compensation and boards of directors. First, compensation systems can be designed to align the interests of owners and managers, such as paying managers in part with shares of stock or stock options, so that their personal wealth is enhanced when the value of the firm is increased. Then, of course, there is arguably the single most important corporate governance mechanism: the board of directors.

Role of Board of Directors

The presence of a board of directors is nearly universal among complex organizations. In business organizations, boards of directors are selected by the owners of the organization to represent them in overseeing the organization. Boards of directors serve two primary purposes. First, they play an advisory role, lending their expertise to management of the firm. Second, they play a monitoring role, in which they monitor the actions of management to assure that managers are providing accurate information about the firm and acting in the best interests of the firm's owners. The board of directors has been called "the ultimate internal monitor." (Fama, 1980)

Membership on a board of directors can be divided into two broad categories: inside directors and outside directors. First are inside directors, who, in addition to serving on the board, also serve as managers within the firm. Inside directors clearly bring to the board significant expertise and detailed knowledge of the firm's operations. However, they may have conflicts of interest in terms of serving as monitors of management, since they are part of management themselves. The second type of board member is an outside director, who does not serve as a manager within the firm. Outside directors may bring expertise to the board that does not otherwise exist within the firm. In addition, outside board members are arguably more effective monitors of management than inside board members. First, since they do not serve as managers of the firm, they do not have the incentive conflicts involved with monitoring themselves. Further, outside board members have incentives to perform their monitoring role well, because their reputation as good monitors will increase their likelihood of being asked to serve on the boards of other firms.

Despite the value of outside directors in providing monitoring services, adding outside members to the board also imposes costs. Outsiders will not likely have the intimate, detailed knowledge of the day-to-day operations that an insider has. Educating outside board members about the operations of the firm, and keeping them appropriately updated on what is happening within the firm, may be expensive and time-consuming. This is likely especially true for firms experiencing rapid growth or for those that have very complex operations. Thus, it is not obvious that having more outside directors is always superior to having fewer outside directors.

In practice, firms vary widely in terms of the composition of their boards of directors, ranging from those with a small proportion of outsiders to those with a large majority of outsiders on the board. Why is this? It is possible that boards are structured haphazardly,

Enya He, Ph.D., is an assistant professor of risk management and insurance in the College of Business at the University of North Texas. Dr. He received her MBA from the University of Miami and her Ph.D. from the University of Georgia and has published articles in the *Journal of Risk and Insurance*, *Risk Management and Insurance Review*, the *Journal of Insurance Issues and Risk Management*. She is a member of the American Risk and Insurance Association (ARIA) and Southern Risk and Insurance Association (SRIA). She is also a fellow of the Chartered Insurance Institute of Britain.

David W. Sommer, Ph.D., is the Charles E. Cheever Chair of Risk Management in the Bill Greehey School of Business at St. Mary's University. Dr. Sommer received his M.A. and Ph.D. from the Wharton School of the University of Pennsylvania. He has published articles in a wide variety of journals, including the CPCU Journal, the *Journal of Risk and Insurance*, the *Journal of Insurance Regulation* and the *Journal of Insurance Issues*. He is currently president-elect of the American Risk and Insurance Association.

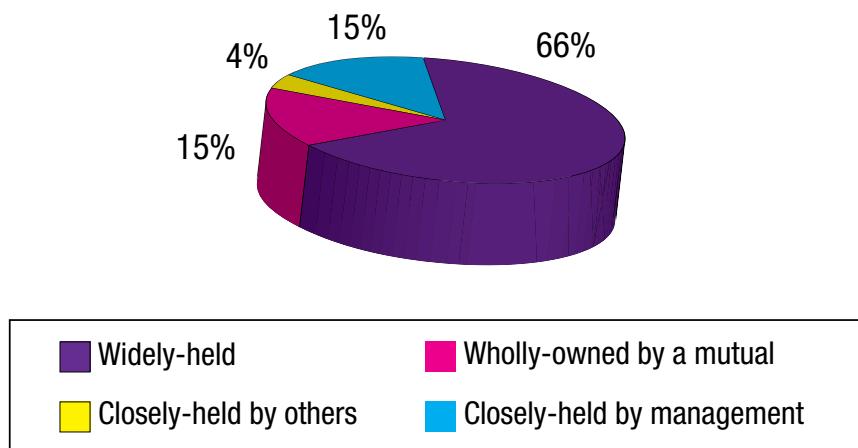
L. Lee Colquitt, Ph.D., is the Woodruff Professor of Risk and Insurance in the Finance Department at Auburn University. Dr. Colquitt received his MBA and Ph.D. from the University of Georgia and has published articles in leading risk and insurance journals, including the CPCU Journal, the Journal of Risk and Insurance, the Journal of Insurance Issues, the Journal of Insurance Regulation and the North American Actuarial Journal. He is a member of the American Risk and Insurance Association (ARIA), Southern Risk and Insurance Association (SRIA), Western Risk and Insurance Association (WRIA), and the Risk Theory Society.

and thus no clear rationale can be provided for why board composition varies by firm. Alternatively, however, it seems more plausible that boards are generally structured in a more systematic manner, in ways that further the goal of maximizing the wealth of the owners who ultimately appoint the board members. If this is true, then we should find systematic differences in board composition across firms with different characteristics. For example, if some firms are likely to be particularly susceptible to incentive conflicts between owners and managers, we would expect boards of those firms to have a higher proportion of outside board members, all else being equal. An interesting place to investigate this issue is the property-liability insurance industry, which has firms with widely differing levels of potential conflicts between managers and owners.

Ownership Structures Within the Property-Liability Insurance Industry

Broadly speaking, the two most predominant organizational forms in the property-liability insurance industry are stock insurers and mutual insurers. Of course, the primary difference between the two is that stock insurers are owned by the stockholders of the firm and mutual insurers are owned by the policyholders. In each case, the owners (stockholders or insureds) vote to elect members of the board of directors, who then appoint executives to manage the company. Clearly, a separation of ownership and control can exist with both organizational forms and result in agency costs to the owners. However, the degree of such separation varies, and such variation leads to differing agency costs, which requires varying approaches to confront these potential costs. Such differences in separation of ownership and control are not only found between stock and mutual insurers, but are also present among stock insurers with varying types of ownership. First, how widely held ownership of a firm is can make a difference in the degree to which management needs to be monitored. Second, who owns the company is also meaningful when considering the issue of separation of ownership and control. Figure 1 breaks down stock insurers with regard to how widely held the firm is and to the type of owner (inside vs. outside ownership).³

Figure 1 – Ownership Structure of Stock Insurers



As shown in Figure 1, the sample stock insurers are mostly widely held (the company itself or its ultimate parent is publicly traded, and ownership ultimately rests with numerous individual stockholders), with this classification making up approximately 66.5 percent of all sample stock insurers. Of the remaining sample stock insurers, 14.9 percent are wholly owned by a mutual company, and 18.6 percent are closely held (a majority ownership rests with one or several individuals, or with a single

family). Of the closely held insurers, roughly 80 percent (14.9 percent of all stock insurers) are closely held by the firm's management, and approximately 20 percent (3.7 percent of all stock insurers) are closely held by parties other than management.

The Implications of Ownership Structure on the Need for Monitoring Management

The greater the separation between ownership and management, the more likely it is that management will be able to effectively serve its own interests over the owners'. Among the various ownership structures described above, the one with the most significant separation between ownership and control is the mutual firm, where certain corporate governance mechanisms are not available. For example, stock-based compensation packages that directly align the interests of management with those of the owners are not feasible in mutual firms. In addition, the possibility of a hostile takeover does not exist, given that there are no shareholders. The closest thing to an external takeover of a mutual firm is a proxy fight waged by the policyholders, a relatively expensive and difficult proposition, given that each policyholder has only one vote. As a result, the corporate control mechanisms in the mutual company are much more restricted than those for the stock insurer.

With stock companies, there are varying degrees of separation of ownership and control, depending on the makeup of the current ownership. In most stock companies, management is disciplined by the possibility of their replacement through a hostile takeover. In the event that management operates inefficiently, investors in the market can identify this inefficiency, gain a controlling interest in the company, and change the management. Again, this threat varies, depending on the ownership. In some situations, the takeover threat is more pronounced than in others. As shown in Figure 1, stock firms are wholly owned by a mutual company, widely held, closely held by outside investors, or closely held by the management of the firm.

While still a stock company, a stock company that is wholly owned by a mutual lacks the effective monitoring mechanism of an outside takeover. This is because the stock of a mutual-owned stock company is not publicly traded and is ultimately owned by the mutual parent's policyholders, making the possibility of an outside takeover or a successful proxy fight remote. With this type of ownership, the threat of an outside takeover effectively resembles that of a mutual company. As a result, the agency costs with this form of ownership structure are higher than those with other stock firms.

For stock companies that are either widely held or closely held by outsiders, the threat of a management breakup either by way of a hostile takeover or by action initiated by current ownership becoming frustrated is very real and can be an effective monitoring mechanism. The investing public can observe the untapped potential of a widely held company operated by unproductive management. In a case such as this, the costs of an external takeover are relatively low. In the case of the firm that is closely held by outsiders, the threat of current ownership ousting ineffective management is even greater. These controlling outside owners have tremendous power to make whatever changes in management they deem to be necessary.

In the case of a stock company that is closely held by management, separation of ownership and control is significantly less than with any other ownership structure. Although it is still possible that the management may have some incentive to extract rents from the firm, such benefits are offset by the fact that they are also shareholders who benefit financially from an effectively run company. In effect, if the company does well financially, then the management does as well. As a result, the need for the monitoring of management behavior by owners is very low with this form of ownership, since owners and managers are one and the same.

Based on the above discussion, the ranking, from greatest to least separation of ownership and control among the differing ownership structures, is mutual firms, mutual-owned stocks, widely held stocks, stocks closely held by others (not management), and stocks closely held by management. That is, the greatest separation is with the mutual firm and the least is with the stock firm that is closely held by management. In addition, the corresponding need for effective monitoring by a board of directors is similarly ranked, with the greatest need for monitoring existing with the mutual firm and the least need existing with the firm that is closely held by management.

How Boards Can Be Structured to Address the Varying Needs for Monitoring Management

As mentioned earlier, one way in which the management of a firm can be effectively monitored internally is through the oversight provided by a board of directors. The management answers to and can be changed by the board. We also have seen that differing ownership structures lend themselves to varying needs for oversight by board members. Again, this is due to the availability (or lack thereof) of other internal and external monitoring mechanisms.

Although the specific firm and industry expertise of the internal board member is helpful to the firm, there exists a conflict of interest with regard to the internal board member's ability to monitor management; the conflict being that the internal board member, by definition, is a part of the firm management. In situations where there exists a need for additional monitoring beyond that provided by other mechanisms (for example, the mutual firm), an external board member is helpful. In addition, the greater the percentage of outside board members, the greater the degree of monitoring that is provided by the board. Finally, if a majority of the board is made up of outsiders, voting control is also with the outsiders, providing an even more effective monitoring mechanism. In fact, a board made up largely of outsiders might be one of the only effective ways in which the management of a mutual or mutual-owned stock firm can be monitored.

With the continuum that exists between the separation of ownership and control with regard to ownership structure, we should expect to see differing degrees of external board member participation with the various ownership structures mentioned above. Given a sample of over a thousand property-liability insurers spanning a period of nine years, we are able to determine if, in fact, boards appear to be haphazardly constructed or whether there is some systematic structuring of boards in ways we would presume to be most helpful in terms of monitoring of management.

Using the data set described earlier, Table 1 provides a breakdown of the sample insurers by the broader organizational form categories of stock and mutual insurers. As stated above, we note that there is a greater need for internal monitoring of mutual insurers as compared to stock insurers, given the lack of effective external monitoring that exists with mutual insurers. As shown in Table 1, the mean (median) percent of outside directors for the sample mutual insurers is 74 percent (78 percent) and for stock insurers it is 47 percent (50 percent). This finding supports the notion that firms do not organize their boards haphazardly, but rather with the monitoring needs of the firm in mind. Additionally, we find that the 88 percent of mutual insurers have outsider-dominated boards as compared to 47 percent of stock insurers. This is also consistent with the hypothesis that mutual insurers need greater monitoring by board members who are not otherwise affiliated with the company.

Table 1
Mutual and Stock Board Composition

	Mutual		Stock	
	Mean	Median	Mean	Median
Board size	10.10	9.00	7.84	7.00
% of outside directors*	0.74	0.78	0.47	0.50
% of firms with outsider-dominated boards**	0.88	1.00	0.47	0.00

*Outside directors are non-officer, non-family directors, where family members are those having the same last name as the firm's officers.

**Outsider-dominated boards are boards whose proportion of outside directors is more than 50 percent.

As discussed earlier, the role of the inside director is an important one; the inside director brings significant expertise and a detailed knowledge of the firm's operations to the board. Of course, in the event that outside directors are added to monitor management, the outside directors' participation would dilute the board of the insiders' expertise, assuming that the board size remains the same. Given the need for a company to preserve the contribution that the inside director makes to the board, we expect that a board with a greater percentage of outside board members might also have a larger number of board members. This would allow the outside board members to be added without removing an equal number of insiders from the board. Consistent with this hypothesis, we find that the mean (median) board size of the mutual insurers, those who tend to have greater numbers of outside directors, is 10.10 (9.00), as compared to 7.84 (7.00) for stock insurers.

Table 2 breaks down the sample stock insurers into four categories of ownership; mutual-owned, widely held, closely held by others, and closely held by management. The table reports the board composition of each with regard to mean and median outside versus inside board membership. The previously described continuum of the separation of ownership and control suggests that we should see differing board compositions with the various categories of stock ownership. The results that we find are largely consistent with our expectations. As shown in Table 2, the category with both the greatest percentage of outside directors and the greatest percentage of firms with outsider-dominated boards is the mutual-owned stock company, with 64 percent and 72 percent, respectively. This is expected, given this category's strong need for monitoring by the board. In addition, these firms also have the largest boards, with an average of 9.26 members. Firms closely held by management, the stock insurer category with the least need for board monitoring, is also the category with the lowest percentage of outside board members and the lowest percentage of insurers with outsider-dominated boards, with 35 percent and 28 percent, respectively. Consistent with expectations, these firms also have the smallest boards, with an average of 6.63 members.

In Table 2, the two stock categories that are between mutual-owned and closely held by management with regard to monitoring by the board are widely held and closely held by others. We find the percentages of outside directors and outsider-dominated boards of the two categories to be between the categories of mutual-owned stock and closely held by management. However, the positions are switched; we find that the boards of widely held insurers are less heavily populated by outside board members than are those of the closely held by others category. This result could be explained, in part, by the relatively small sample of insurers in the closely held by others category, making conclusions potentially unreliable for this category.⁴

Table 2
Stock Ownership Structure and Board Composition

	Mutual-owned		Widely held		Closely held by others		Closely held by management	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Board size	9.26	9.00	7.87	7.00	6.40	6.00	6.63	6.00
% of outside directors*	0.64	0.70	0.46	0.46	0.57	0.57	0.35	0.33
% of firms with outsider-dominated boards**	0.72	1.00	0.45	0.00	0.56	1.00	0.28	0.00

*Outside directors are non-officer, non-family directors, where family members are those having the same last name as the firm's officers.

**Outsider-dominated boards are boards whose proportion of outside directors is more than 50 percent.

Conclusion

Using a rich dataset from the property-liability insurance industry, we show that board structure of property-liability insurers is not haphazardly determined as some have suspected. Instead, we show that boards in this industry are generally structured in a more systematic manner, in ways that appear to further the goal of maximizing firm value. Such findings have important policy implications in the post-financial crisis era. While some are calling for more stringent regulation of financial services industry, our results seem to indicate that firms are not as inefficient as some might have expected. The imposition of uniform rules for the structure and composition of corporate boards may therefore be counterproductive. The findings may also prove useful to both those inside and outside a property-liability insurer who are evaluating the appropriateness of the firm's board structure. A clear implication of our results is that one cannot look at the characteristics of a board in isolation and determine whether or not the board structure and composition are "good" or "strong."

References

Brickley, James A. and Jerold L. Zimmerman (2010). "Corporate Governance Myths: Comments on Armstrong, Guay, and Weber." Simon School Working Paper No. FR 10-29. Available at SSRN: <http://ssrn.com/abstract=1681030>.

Fama, E. F. (1980). "Agency problems and the theory of the firm." *The Journal of Political Economy* 88(2): 288-307.

He, E. and D. W. Sommer (2010). "Separation of Ownership and Control: Implications for Board Composition." *Journal of Risk and Insurance* 77(2): 265-295.

Endnotes

1. This article is based on an academic research paper. Readers interested in deeper analysis of the topics discussed here are referred to He and Sommer (2010).
2. See Brickley and Zimmerman (2011) for a complete discussion of these misguided beliefs about corporate governance.
3. The information on corporate management and boards is collected from the Best's Insurance Reports Property/Casualty 1996 through 2005 editions. The ownership information on mutual vs. stock is from the NAIC database, 1995 to 2004. The detailed stock ownership information is hand-collected from various sources, including Best's Insurance Reports, LexisNexis Academic Database, Dun & Bradstreet Million Dollar Database and company websites. See He and Sommer (2010) for a complete description of sample selection criteria. All firms are categorized in terms of ultimate ownership. For example, any insurer that is part of a publicly traded insurer group is categorized as publicly traded.
4. He and Sommer (2010) perform more sophisticated regression analysis, and the results described here are upheld in that more rigorous analysis.