

Producing Credible Results

The Role of Corporate Governance

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39th Annual Seminar of the International Insurance Society
New York, July 15, 2003

Undoubtedly, the credibility of managers has suffered in recent years. Corporate malfeasance, the bursting of the dot.com bubble, and a three-year back-to-back decline in the stock market have shaken up investor confidence. Widespread assumptions that companies would generate an ever-increasing stream of earnings have – rightfully – proven wrong. But the damage is done. Corporate leaders all over the world had their share of irate shareholders venting their frustration at the annual general meetings of the companies they were investing in. Now is the time to rebuild trust and credibility. Trust, as a wise mentor once taught me, comes in 50-gallon drums. Unfortunately, these drums spill easily, and it takes a long time to refill them because they can be replenished with small spoons only.

The first priority in the business of rebuilding trust and credibility in the marketplace must be the restoration of profitability. This is particularly true in the insurance industry where exceptional losses in combination with the sharp stock market decline have exposed underlying weaknesses. At Zurich Financial Services, for example, management is taking a very hard look at the Life business, ensuring that, going forward, the company can generate attractive earnings that are sustainable in all financial market conditions. Zurich is concentrating on profitable core businesses, and the company is divesting of activities that are either non-core or do not meet the internal earnings hurdle rate. There is a laser-sharp focus on financial discipline, solid underwriting and tight claims management. We are improving our internal and external reporting. For the first time in our company's history, we reported quarterly results this spring in order to demonstrate that we have a grip on our financial numbers and that we are in control of our business. Finally, we are deploying early warning systems and we are developing contingency plans that can make up for

changes in the environment that may negatively affect us. We are determined to deliver value to all our stakeholders: shareholders customers and employees.

This is an ambitious program, and the implementation of tough choices places tall demands on any organization and its employees. People always resent change; but they also abhor uncertainty. That is why we are moving forward with a heightened sense of urgency, and this is true for the whole industry. We must deliver, and we must do it now. This requires concentration on the job at hand. It is absolutely crucial to put the right people in the right jobs, and we must be prepared to recognize performance and behavior. Executive remuneration has come under attack recently. I would agree that the relationship between base salaries and bonus payments needs to be rebalanced with fixed payments and variable compensation that are tied to well-defined performance targets. But if these targets are met, executives should be rewarded, for as long as the right targets are met, any company will be stronger in the long term.

The issue of executive compensation highlights a fundamental problem of corporate governance, often defined as attempting to reconcile the irreconcilable. Indeed, controlling a company's management on behalf of its shareholders is no trivial task, because the interests of the two parties are not necessarily aligned. By commissioning a board of directors with the oversight of a company, shareholders would like to ensure that management is not doing foolish things with their money. The reason why corporate governance has moved to the front burner today is that investors believe that management has been engaging precisely in such imprudent activities. Let me make three observations in this context.

First, we should question whether the recent wave of increased regulation and enhanced supervision will serve us well. Of course, calls for better corporate governance, increased transparency and more efficient financial markets are like motherhood and apple pie – who could be against them? But it would be a fallacy to assume that more rules are always the better solution. Even the best intended legislation will not prevent future failures. Merely adjusting legal and regulatory controls disregards the ingenuity of the human mind; it will always find a way to legally bypass inconveniences. There is also a fine line where reporting requirements become burdensome or meaningless. Consequently, issuing new

laws is symptom therapy at best, and not treatment of the root causes.

Second, I would like to warn against running after fads. I am old enough to remember when Japan's model of corporate governance – “The sun always rises in the East” – was being celebrated as the salvation of the West. US companies were considered as one step short of being taken over by their Japanese competitors, or the Rockefeller Center and Pebble Beach being bought up by Japanese corporations. How times change. For a while in the nineties it was a given that American companies had it all, from the right incentives structure down to the appropriately transparent accounting procedures under US GAAP. Conventional wisdom was that it would only be a matter of time until the whole world had adopted US standards. Fast-forward the reel to today and we recognize that convergence to the US model looks quite unlikely; In fact, I believe it will never be a realistic option.

This also concerns the current attempt to move **insurance accounting** to a **fair value** standard under IFRS (formerly IAS). My first concern is on the **practicality** of fair value as the industry is faced with the need to **refocus its business portfolio** and **strengthen its balance** sheet. Add to that the **high cost** involved with investments in **IT hardware** and **software**. In addition to that our organizations would need time to **price new products** and **restructure its portfolio**, while regulators, rating agencies and analysts need information and time to understand the new metrics. Finally, there is a concern about a **level playing** field. The insurance industry is asked to report using fair value to **an extent not required** for other industries and businesses and most likely not applicable to it. If properly applied, fair value would have an impact not only on financial sector firms but on **all capital market participants**. Thus, given the current state of our industry, and the impracticality of determining and reporting fair value in an appropriate and consistent manner, we question the opportunity of moving along the current schedule in such a short time frame. Fair value may well come, but we propose to **proceed not now** and **not in its current format**, and certainly not before the cost and benefit of fair value accounting are properly understood.

My third observation is based on the view that regulation is often the enemy of diversity because it tends to homogenize. Regulation cannot coexist with diversity. Regulators will always desire to apply the same rules to similar cases or events. They are not prepared to accept exemptions for fear that regulation would become unworkable or unenforceable.

But first principles of portfolio theory suggest that a variety of regulatory approaches is likely to make the world less risk-prone than a uniform approach. Homogenized regulation would be akin to putting all eggs in one basket, and that is a surefire prescription for unwelcome surprises. This, in my mind, is a powerful argument against uniformity of rules across borders. Of course, it is true that we live in a global world and that new rules concerning corporate governance will have to evolve in a global context. But a one-size-fits-all approach is not the right solution. Rather, new laws and regulatory rules should take into account cultural differences and local traditions. There needs to be room for different solutions and mutual recognition of individual practices, and I am encouraged by the recent developments that would allow for more country-specific and company-specific solutions in the regulation and supervision of the financial services industry. But I am skeptical about the rhetoric. That is a reason why now, more than ever, it is important that a constructive transatlantic dialogue on all regulatory issues is maintained. As a traveler on both sides of the Atlantic, I am very much aware of local practices and traditions and I know that there is no superior model that simply waits adopting.

The attention our topic has provoked on both sides of the Atlantic suggests that the issue is not only the presence or absence of good corporate governance, but rather on how we view corporations and their role in the economy. In this context it is crucial to recall that a corporation has a fiduciary obligation towards the capital entrusted to it. Investors buy shares, and creditors lend capital, if they have a reasonable expectation that the company will make enough money to pay dividends and service its debt. Earning a profit is instrumental in telling the financial market that the company will precisely do so. Regretfully, the business of wealth creation has been tarnished in the eyes of the public. But the often-heard wholesale criticism of the profit motive points to a fundamental misunderstanding of how market economies function. Companies incapable of earning a profit will cease to exist. Consequently, they will stop generating jobs, income and wealth.

In this market perspective it is important to recognize that the success of the corporation depends on the quality of entrepreneurial decisions taken. Consequently, executives need to be in a position to execute. Corporate failure is, in many cases, not the result of executive abuse but of reliance on bad products or failure to recognize and react to a changing environment. Thus, failure will always be a reality when implementing corporate decisions. But prevention of failure cannot be demanded by legal requirements. We should

bear in mind that too many checks and balances can lead to imbalance and checkmate. Thus, proper regulation should not attempt to substitute for market forces. Interference with markets will only lead to paralysis. The challenge becomes one of finding efficient ways to promote well-functioning markets. Economists tell us that information deficiencies will lead to market failures. Ensuring a timely and accurate flow of information goes a long way in providing the basis for a well-functioning global market-driven economy. In other words, the requirements of transparency and sound information policies are key to the solution of many problems related to corporate governance.

Going forward, the noble task will be to rebuild reputation, trust and credibility of the market players. As SEC Chairman William Donaldson recently observed, “Even many of the most well intended firms that were consistently mindful of corporate governance got caught up in the boom time. Frequently, conceptions of responsible corporate governance were adjusted to accommodate the temptations of a runaway bull market. As the band played faster and faster, standards began to erode throughout the business community.”

This has to change. Ethical behavior must again become an integral part of a company’s culture. It is crucial that the companies in all industries communicate the right signals. It does not suffice to be only meeting financial targets. Our actions must be based on **long-term interests** rather than on **short-term, expedient solutions**. This requires us to **manage our businesses with integrity**, and cultivating long-term relationships with our customers that are based on trust. But merely expanding the body of existing rules and regulations will not and cannot ensure this behavior. The better approach lies in instilling fundamental principles that focus on the spirit, not just the letter of good corporate governance. This is a clear preference for principles over rules, and the principles on which we must focus are few. They include:

Transparency: Reducing unequal access to information and leveling the playing field for all members of a market economy is key. We have probably not exhausted all possible disclosure obligations. But we should be mindful of the trade-off between meaningful transparency and stifling disclosure. In some cases, I would like to caution our regulators, less can truly be more.

Integrity: Corporations need to make it a point to recruit people with a high level of

integrity and sound judgment. This holds true not only for executives, but also for directors who are responsible for defining the corporate culture based on credibility and trust.

Accountability: Non-performance will not be tolerated, and performance criteria should include more than just the financial targets of the business plan; indeed, we must reward performance and behavior. Of course, it should be needless to say that performance and behavior are also issues for directors, since they are ultimately accountable to shareholders.

The balance is that transparency, integrity and accountability will go a long way in resolving many of the real and perceived problems associated with corporate governance. But we need a balanced approach that relies on fundamental principles and puts the right emphasis on the corrective forces of markets in which we operate. Of course, principles alone do not guarantee performance, but they will ensure credible results.