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## Board risk committees: Insurer financial strength ratings and performance

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## ABSTRACT

We hypothesize and find that the existence of a board risk committee is positively related to A.M. Best's Financial Strength Ratings, a measure widely used in the insurance industry to assess financial health. Using a sample of insurance firms from 2007 to 2013, we measure the impact of board risk committees on financial strength ratings and performance after controlling for various factors such as corporate governance characteristics. We find that firms with board risk committees report higher financial strength ratings, but only in the post-financial crisis period. Also, the formation of a board risk committee is positively associated with an increase in financial strength ratings from the year prior to committee formation to the year after committee formation. Further, we find that the presence of a board risk committee is not related to short-run firm performance benefits and that it takes five years for the presence of a board risk committee to be associated with future performance. Overall, our results provide evidence suggesting board risk committees are effective and beneficial from the standpoint of rating agencies and long-term financial performance.

## 1. Introduction

In a corporation, the board of directors bears the primary responsibility for risk management (Tonello, 2012). Dedicated, stand-alone risk committees (board risk committees)<sup>1</sup> have arisen as a mechanism for delegating this obligation. Board risk committees have received increased attention, especially since the global financial crisis (COSO, 2009; Deloitte, 2011; Hines et al., 2015; Nixon Peabody, 2010). Theoretically, board risk committees identify risks and, where possible, mitigate or optimally manage them. However, the implementation of a board risk committee can be costly in terms of both time and resources. In addition, detractors argue that the greatest cost associated with a stand-alone risk committee may be the challenge of helping the board of directors fully integrate information provided by a separate committee (Bates and Leclerc, 2009). Our fundamental research question is whether a board risk committee impacts realized firm performance and adds value from the standpoint of rating agencies. We provide evidence related to potential board risk committee effects on firm performance as well as the perceptions of external evaluators regarding the value of board risk committees.

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<sup>1</sup> In practice, risk committees can be adopted at the board level or at the management level. All risk committees discussed in this paper refer to risk committees formed at the “board-level” for parent firms. For our study, if the parent’s proxy statement includes a board committee with “risk” in the committee name, then insurers in that parent group are deemed to have a board-level risk committee. Examples of risk committee names include “risk management”, “credit and risk management”, “asset/liability risk”, and “risk and compliance.”

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In the aftermath of the financial crisis, financial firms were under intense scrutiny by congressional leaders and regulators due, in part, to governance failures being attributed to the financial crisis fall out. As part of the Dodd Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) enacted in 2010, section 165 requires public nonbank financial firms that report directly to the Board of Governors of the Federal Reserve System to form a board-level risk committee. Our study attempts to shed light on the potential firm effects of this type of risk governance mechanism that regulators focused on after the financial crisis.

We obtain a sample of 2,378 property and casualty (P&C) insurer-years from 2007 to 2013. We focus on insurers for several reasons. First, risk management is particularly important for insurers because their business model is wholly predicated on the ability to properly identify and price risk. Second, board risk committees are much more common among firms in highly regulated industries (Bates and Leclerc, 2009). Third, focusing on a single industry provides for higher internal validity by eliminating cross-industry variation.

In order to measure the impact of a board risk committee from a regulatory standpoint, we use A.M. Best’s Financial Strength Rating, which represents an independent opinion of insurer financial health. This financial strength rating is “recognized worldwide as the benchmark for assessing and comparing insurers’ financial strength (A.M. Best, 2012).” The stakes associated with ratings are high (Kisgen and Strahan, 2010). Changes in a financial strength rating can have a dramatic impact on access to capital, cost of capital, and revenue from premiums. Even an incremental change can significantly alter an insurer’s financial prospects. However, ratings tend to be consistent over time (Ayers et al., 2010; Düllmann et al., 2000; Mora, 2006). Thus, identifying factors that influence these financial strength ratings, even incrementally, is valuable from a firm’s perspective. Consequently, financial strength ratings represent a powerful setting to identify the potential benefits of the existence and efforts of a board risk committee.

Our paper builds on two growing research streams. The first is research that focuses on the characteristics and impact of board risk committees (e.g., Hines et al., 2015). The second is research documenting the determinants of financial strength ratings (e.g., Ames et al., 2014). We find that, after controlling for other relevant factors, firms with a board risk committee report higher financial strength ratings, but only after the financial crisis began in 2008. We also find evidence that suggests firms adopting a board risk committee experience an immediate increase in financial strength ratings from the year prior to committee formation to the year after committee formation. However, we find that board risk committee age (i.e., the length of time that a board risk committee has been in existence) is not significantly related to ratings. In further tests, we find that the presence of a board risk committee is not related to short-run firm performance benefits and that it takes five years for the presence of a board risk committee to be associated with performance. Overall, our results suggest insurer external evaluators may have responded to the presence of board risk committees in the post-financial crisis period with fairly immediate higher assessments of financial strength whereas it takes an average of at least five years for insurers to realize positive performance effects. Also, this response by external evaluators may have been more sensitive after the financial crisis began when regulators monitored insurer board-level governance mechanisms more closely.

Our contribution is threefold. First, we provide evidence that benefits exist for firms adopting a board risk committee, which suggests insurers do not simply use board risk committees to solely establish legitimacy with stakeholders. Second, we find that benefits in the form of perceived risk by external evaluators occur within one year while positive firm performance effects are not realized until five years after risk committee adoption. Finally, we provide evidence that these benefits from ratings only accrue after the financial crisis when insurers and regulators came under greater scrutiny. The remainder of the paper proceeds as follows. In Section 2, we discuss the background and hypotheses. Section 3 provides the sample and methodology for our hypothesis tests. Section 4 shows our results, and Section 5 concludes.

## 2. Background and hypothesis development

### 2.1. Risk governance and oversight

Risk governance refers to risk management-related corporate governance mechanisms, such as chief risk officers and board risk committees. Since the turn of the century, there has been much discussion about the importance of risk governance, both in practice and from a research perspective. Beasley et al. (2005) suggest that public policy problems are at stake if board-level governance mechanisms are not adopted to address enterprise-wide risks. They indicate that enterprise risk management (ERM) is “designed to increase the board’s and senior management’s ability to oversee the portfolio of risks facing an enterprise (Beasley et al., 2005, 522).” Additionally, Lundqvist (2015) purports that ERM is comprised of both traditional risk management techniques and risk governance mechanisms and that specific risk governance action goes beyond traditional risk management. The primary focus of risk governance has been firm-wide risk management integration.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2009) indicates that primary responsibility for oversight of risk exposure and risk management practices resides fully with the board of directors. Corporate governance failures during the recent financial crisis sparked debate among regulators and professionals regarding best practices for risk oversight structure at the board level. Much of this debate focused on whether risk oversight practices should fully reside with the board as a whole, or if risk oversight should be assigned to either the audit committee or a separate board risk committee (Protiviti, 2011). The New York Stock Exchange Listed Company Manual requirements allow a separate board committee to have risk oversight responsibility as long as the audit committee reviews that oversight function (Bates and Leclerc, 2009).

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