

Draft for Discussion – June 30, 2004

Information Bulletin – Related Party Transactions and Conflict of Interest Procedures

This bulletin applies to all companies registered to conduct insurance business in Jamaica.

A. Background

Related party transactions are a complex issue for supervisory agencies. These transactions are troublesome because unlike normal transactions in the market place where two independent parties negotiate terms and prices to their satisfaction before a transaction is consummated; related party transactions do not involve independent parties. As a result, there is concern by financial institution supervisors that related party transactions have the potential to not be at fair market value and not in the best interest of the supervised entity.

This is not merely a theoretical concern. World wide, financial institution supervisors have often seen financial institutions, including insurance companies, raise funds from the public and then rather than wisely invest the funds, move them to a parent or associated company. From there, the funds are channeled into various entrepreneurial enterprises, many of which will not generate sufficient cash flow to repay the obligations of the financial institution. A significant proportion of financial institution failures have, in fact, been the result of inappropriate related party transactions. In fact, a study from the United States found that inappropriate related party transactions were a major factor in over one third of bank insolvencies.

The inappropriate movement of funds to related parties can take a number of forms including:

- Excessive dividend payments to the parent company relative to the income of the insurance company;
- Investments, loans or deposits to a parent company or other related party at less than market rates of return;
- The extension of credit to a parent company or other related party with no serious attempts to collect the outstanding receivables;
- Sales of assets or services to a parent company or other related party where the sales price is less than market value;

- Asset or service purchases from a parent company or other related party where the price of the asset or service is in excess of market value;
- Management agreements with the parent company or other related party where the management fees are greater than what a third party manager would charge for the same service;
- Rental agreements with the parent company or other related party where the rent paid (received) is greater (less) than fair market value;
- Joint ventures with the parent company or other related party that are structured such that the insurance company pays a high proportion of the costs, but receives a low proportion of the benefits; and,
- Loan guarantees on behalf of the parent company or other related party with no guarantee fee being charged.

At the same time it is recognized that a number of insurance companies in Jamaica are members of groups of companies. In this context, it makes economic sense for these insurance companies to transact business with associated companies. From an economic perspective, it is clear that an insurance company that requires deposit services would prefer to obtain those services from an affiliated company rather than that company's competitor. Similarly, it makes economic sense for an insurance company to market its products through an affiliated insurance agency or brokerage.

The key to the related party issue is to devise a system where related party transactions can be undertaken if they are at fair market value, in the normal course of the insurance company's business and in the best interests of the insurance company. This is the purpose of Regulations 74, 81, 82, 83, 84, 85, and 86 of the Insurance Regulations.

These regulations are complex and difficult to understand. In addition, these regulations contain some drafting errors and steps are currently being taken by the Financial Services Commission ("FSC") to correct those errors.

The purpose of this bulletin is two fold. First, the bulletin attempts to summarize the most important related party provisions contained in the Insurance Regulations with the overall intent being to assist insurance companies in understanding their regulatory obligations with respect to the Regulations. Second, the bulletin outlines FSC expectations with respect to the Conflict of Interest Procedures that companies are required to file with the FSC.

B. Summary of Related Party Provisions

1. Establishment of Conduct Review Committee

Regulation 74(1) requires each insurance company to establish a Conduct Review Committee ("CRC"). The Committee is to consist of at least three directors who are **elected** by the full Board of Directors. Principles of good corporate governance suggest that the Chair of the CRC be an independent or unaffiliated director. It is expected that

the members of the CRC will change from time to time as a result of changes in a company's Board of Directors.

2. Conflict of Interest Procedures

Regulation 74(2) requires the CRC to establish "written procedures with a view to identifying situations which create potential conflicts of interest and preventing such conflicts." Regulation 81 requires these procedures to be filed with the FSC within thirty days of the establishment of the CRC. These procedures do not have to be approved by the company's full Board of Directors.

The CRC may wish to change its procedures from time to time. An opportune time to review the procedures occurs when a new member joins the Committee. Any changes in procedures must be filed with the FSC.

3. Identification of Related Parties

Regulation 82(1) outlines an extensive list of related parties to an insurance company. The list includes directors, officers, shareholders, affiliated companies and many other persons. The list is extensive and it is recommended that the CRC review this regulation closely. Regulation 82(2) indicates that for purposes of related party transactions a person is considered to be a related party for one year after that person actually ceases to be a related party.

4. Special Provisions for a Fiduciary

Regulations 82(3) to 82(7) apply to situations where an insurance company is acting as a trustee for a third party. In this case, the trust is prohibited from investing in the securities of the insurance company or undertaking transactions with the insurance company or any of its related parties unless ordered to do so by a court or unless there are explicit instructions to do so in the trust agreement.

In some instances, the trust will contain securities of the insurance company at the time the insurance company becomes the trustee. In such cases, the insurance company is not permitted to sell or vote the securities without first receiving written approval of the company's CRC. The CRC must outline the reasons why permission is being granted. The CRC must also file an annual report to the Board of Directors regarding Trust holdings of insurance company securities and transactions that have occurred with respect to the securities held during the previous year.

5. Restrictions on Related Party Transactions

Related party transactions can take two forms. The first of these are operating transactions including the purchase and sale of goods and services between the insurance company and its related parties. The second of these are investment transactions where

investments are made, loans granted or credit extended (accounts receivable) to a related party by the insurance company or by a related party to an insurance company.

Regulations 82(8) and 82(9) prohibit these transactions unless the transactions are permissible transactions (see Section B.6 of this Bulletin) or unless the transactions have been approved by the Conduct Review Committee (see Section B.7 of this Bulletin).

6. Permitted Transactions

Three types of permitted transactions are outlined in Regulation 83.

- The payment of salaries and benefits to employees and directors of the insurance company is permitted without the review of the CRC on the grounds that these payments are clearly part of the normal course of any company's business.
- The provision of services normally provided by the company to a related party at fair market value is permitted without the review of the CRC. An obvious example for an insurance company is the selling of insurance policies to company directors, company employees or affiliated companies on the same terms and conditions that are made available to all customers of the insurance company.
- The purchase (sale) of goods and services from (to) related parties where the market value of the goods and services is a nominal amount is permitted without the review of the CRC on the grounds that such transactions are considered to be immaterial.

7. Transactions Which Require Conduct Review Committee Approval.

With the exception of permitted transactions, all other company transactions with related parties must be approved by the company's CRC. Transactions must meet a number of requirements before CRC approval can be granted. All of the following criteria must be met for each transaction:

- The transaction must be for a consideration that is at fair market value (Regulation 82(10) and Regulation 85);
- The transaction must not involve the purchase or sale of land (Regulation 84(3));
- The transaction must not involve the exchange of securities between the insurance company and a related party unless the securities are listed on a recognized stock exchange (Regulation 84(3));
- The transaction must be consistent with the usual business of the insurance company (Regulation 84(3)); and,
- The transaction must be in the best interest of the insurance company (Regulation 84(3)).

The CRC should provide approvals in writing and reasons for approval should be outlined in the minutes of CRC meetings.

In some cases, it is not necessary for the CRC to approve specific transactions. Regulation 84(1) allows for CRC approval for a class of transactions. For example, an

insurance company may have entered into an agreement to pay its parent company management fees on a monthly basis. It is not necessary for the CRC to approve each payment on a monthly basis. Rather, the CRC should review the agreement before it is entered into. It can then approve all payments specified in the agreement provided that the agreement meets all the approval criteria.

8. Important Restrictions on Conduct Review Committee Authority.

There are two very important restrictions on the authority of the Conduct Review Committee.

Regulation 82(11) indicates that the CRC **cannot** approve any transaction if as a result of that transaction the **total** amount owing to the insurance company (including accounts receivable, loans, or other security instruments including assets subject to an agreement to repurchase) by all related parties, exceeds 5% of the total assets of the company. Regulation 82(12) requires that the insurance company obtain consent from the FSC before any such transaction can be approved.

Regulation 82(13) prohibits the CRC from approving a transaction or a series of transactions that would result in the disposal of in excess of 10% of total insurance company assets to related parties over a 12 month period. Regulation 82(14) requires that consent be granted by the FSC before such transactions can be approved by the CRC.

The FSC advises that consents under Regulations 82(11) and 82(13) will only be granted under exceptional circumstances.

9. Disclosure by Related Parties

Regulation 86 outlines disclosure requirements that related parties are to make when contemplating transactions with the insurance company. To meet the requirements of this Regulation the related party must disclose in writing to the company's Board of Directors the nature and extent of the related party's interest in the transaction. The Board of Directors is required to record this disclosure in the minutes of the Board of Directors meeting. In addition, the related party must not take part in discussion on the transaction, must not be present when the company's directors are dealing with the transaction or must not in any way attempt to influence the company's decision with respect to the transaction.

C. Conflict of Interest Procedures

As indicated previously, the CRC is required to file its Conflict of Interest Procedures with the FSC (see Section B.2 of this bulletin).

Clearly, the CRC has the responsibility to develop procedures that meet its needs. Nevertheless, the FSC expects the Conflict of Interest Procedures to be consistent with

the related party sections of the Regulations. In this regard, the FSC expects all Conflict of Interest Procedures to address the following issues.

- The procedures should outline a process to ensure that the CRC always has an up to date list of the specific related parties of the company. The FSC will from time to time be doing spot checks to ensure that an up to date list of a company's related parties is being maintained.
- It would be useful for the Conduct Review Committee to notify each of the company's related parties and advise each of the related party disclosure requirements (see section B.9 of this bulletin).
- If the company is acting as a trustee, the procedures should outline the information the CRC requires before making decisions to approve the sale or voting of the company's securities. It would be useful for the CRC to specify criteria for approval in advance and develop an approach to recording decisions. .
- If the company is acting as a trustee, the procedures should outline how the company intends to monitor Trust holdings of company securities for purposes of preparing the annual report to the Board of Directors.
- The procedures should outline the information the CRC requires before making decisions to approve any related party transaction. It would be useful for the CRC to specify criteria for approval in advance and develop an approach to recording decisions.
- The procedures should outline a process to be used to monitor related party balances to ensure that the 5% of assets limit (see section B.8 of this bulletin) is respected.

D. Conclusion

Related party transactions pose a significant challenge for all supervisory agencies including the FSC. Nevertheless, it is recognized that related party transactions are a fact of life. The Insurance Regulations outline a process that allows insurance companies the flexibility to undertake related party transactions provided that an advance determination is made that such transactions are at fair market value, in the normal course of the company's business and in the best interests of the company.

The FSC has the opportunity to assess each company's related party transaction review process through the filing of Conflict of Interest Procedures. The FSC also has the opportunity to review specific transactions or to review the CRC's performance through an on site examination. Finally, the FSC can monitor the level of related party transactions through the filing process and can intervene if a company's related party balances exceed the 5% of assets limit specified in the Regulations.

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