Corporate Governance and Resilience to Financial Crisis

Swiss Insurance Companies in the Interwar Period

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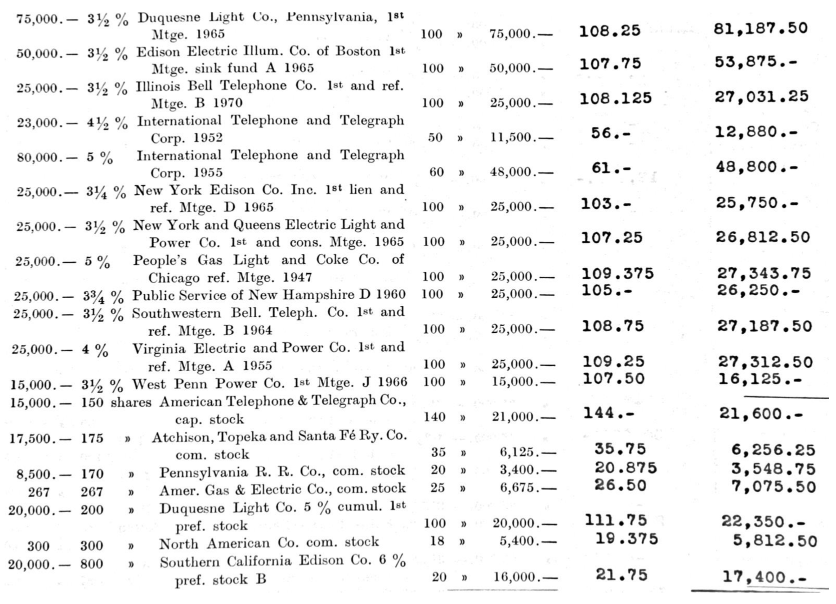
1 Introduction

Financial side of insurance business
Since the beginning of the 20th century, net income on capital assets of the major European insurance companies has exceeded business-operating profit. Therefore, managing the financial assets became one of the most important business activities. This required a fundamental transformation of management, corporate governance and models of how the business and the economic at large worked. Yet, academic research only recently started to focus on the financial side of insurance business and the role of insurance companies as institutional investors.

Resilience to financial crisis
The recent financial crisis (2007-09) sparked a renewed interest in the micro perspective of financial markets. This PhD-project analyzes how corporate governance, financial policy and resilience to financial crisis interacted with each other. Accordingly, the interwar period represents an ideal framework to examine insurance companies' strategies, processes and techniques to reduce vulnerability to financial crisis.

2 Method and Data



75,000.—	3½ %	Duquesne Light Co., Pennsylvania, 1st Mtge. 1965	100	»	75,000.—	108.25	81,187.50
50,000.—	3½ %	Edison Electric Illum. Co. of Boston 1st Mtge. sink fund A 1965	100	»	50,000.—	107.75	53,875.-
25,000.—	3½ %	Illinois Bell Telephone Co. 1st and ref. Mtge. B 1970	100	»	25,000.—	108.125	27,031.25
23,000.—	4½ %	International Telephone and Telegraph Corp. 1952	50	»	11,500.—	56.-	12,880.-
80,000.—	5 %	International Telephone and Telegraph Corp. 1955	60	»	48,000.—	61.-	48,800.-
25,000.—	3¼ %	New York Edison Co. Inc. 1st lien and ref. Mtge. D 1965	100	»	25,000.—	103.-	25,750.-
25,000.—	3½ %	New York and Queens Electric Light and Power Co. 1st and cons. Mtge. 1965	100	»	25,000.—	107.25	26,812.50
25,000.—	5 %	People's Gas Light and Coke Co. of Chicago ref. Mtge. 1947	100	»	25,000.—	109.375	27,343.75
25,000.—	3¾ %	Public Service of New Hampshire D 1960	100	»	25,000.—	105.-	26,250.-
25,000.—	3½ %	Southwestern Bell. Teleph. Co. 1st and ref. Mtge. B 1964	100	»	25,000.—	108.75	27,187.50
25,000.—	4 %	Virginia Electric and Power Co. 1st and ref. Mtge. A 1955	100	»	25,000.—	109.25	27,312.50
15,000.—	3½ %	West Penn Power Co. 1st Mtge. J 1966	100	»	15,000.—	107.50	16,125.-
15,000.—	150 shares	American Telephone & Telegraph Co., cap. stock	140	»	21,000.—	144.-	21,600.-
17,500.—	175 »	Atchison, Topeka and Santa Fé Ry. Co. com. stock	35	»	6,125.—	35.75	6,256.25
8,500.—	170 »	Pennsylvania R. R. Co., com. stock	20	»	3,400.—	20.875	3,548.75
267	267 »	Amer. Gas & Electric Co., com. stock	25	»	6,675.—	26.50	7,075.50
20,000.—	200 »	Duquesne Light Co. 5 % cumul. 1st pref. stock	100	»	20,000.—	111.75	22,350.-
300	300 »	North American Co. com. stock	18	»	5,400.—	19.375	5,812.50
20,000.—	800 »	Southern California Edison Co. 6 % pref. stock B	20	»	16,000.—	21.75	17,400.-

Fig. 1. Reporting every single financial asset to the regulation authority, Federal Archives of Switzerland

Financial resilience
The database entails over 30'000 previously undisclosed records; the data contain every single financial asset of three major European non-life insurance companies of Swiss origin, annually from 1910-1940.
Key data from annual reports, internal reviews, board minutes, further internal decision-making bodies, technical business, stock and bond markets, and regulation authorities, is being collected from various archives.

Corporate Governance
Qualitative evaluation of stakeholders: management, employees, shareholders, regulation authorities and the public.
Network analysis of management and directorate inter-linkages shows inclusion in Swiss corporate governance system and respective recruitment and financial policy.

3 Results

First results are available for Zurich Insurance Company. Key features are:

1. Massive financial reserves
At the end of the 19th century, financial reserves did not reach the yearly gross premium income. In 1940 it accounted 240 % of net premium income. The company was famous for it's inner financial strength. Augmented financial reserves became a significant part of their corporate strategy and identity. This narrative became the dominant self-explanatory model for the company's success-story in the interwar period.

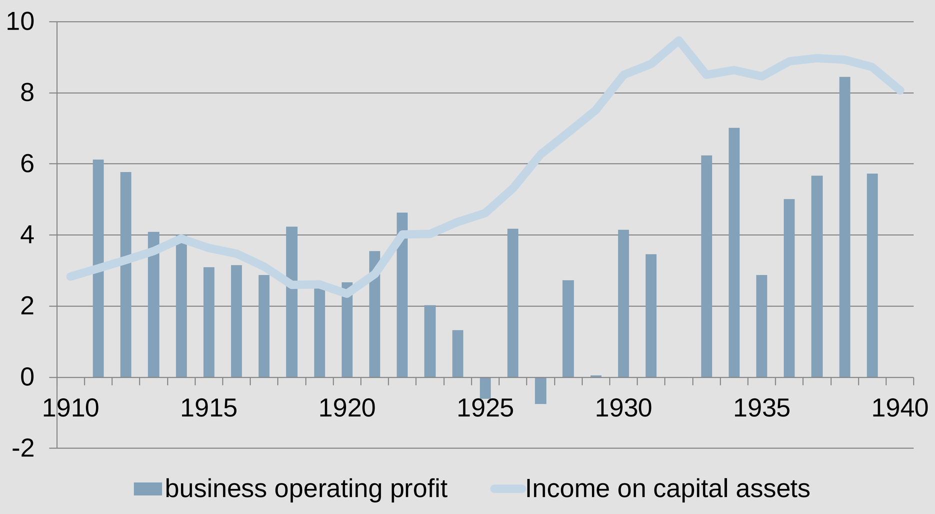


Fig. 2. Annual business profit and income on capital assets of Zurich Insurance Company 1910-1940 (in Mio. Swiss Francs, 1914=100)

2. Hidden reserves
Financial transparency in accounting was low. As a key feature of the Swiss corporate governance system, enormous hidden reserves existed on financial assets. Although they were not publicly declared, the public knew about the widespread existence of hidden reserves in large Swiss companies. As a model for proto anti-cyclical behavior they were promoted by state authorities. Furthermore they were used for stable dividend policy.

3. Conservative asset management
Management of financial assets was located in the highest body (the board of directors). Favorable assets were fixed-interest securities (e.g. bonds), issued or guaranteed by the state. Besides state bonds, railway companies, public utilities provider, power plants and light and telephone companies were considered favorable issuers. Conservative accounting evaluation diminished risks from devaluation and depreciation. Furthermore, financial risk was reduced through balanced currency sheets. Safe havens like the U.S. and Swiss financial markets played a crucial role in the interwar period.

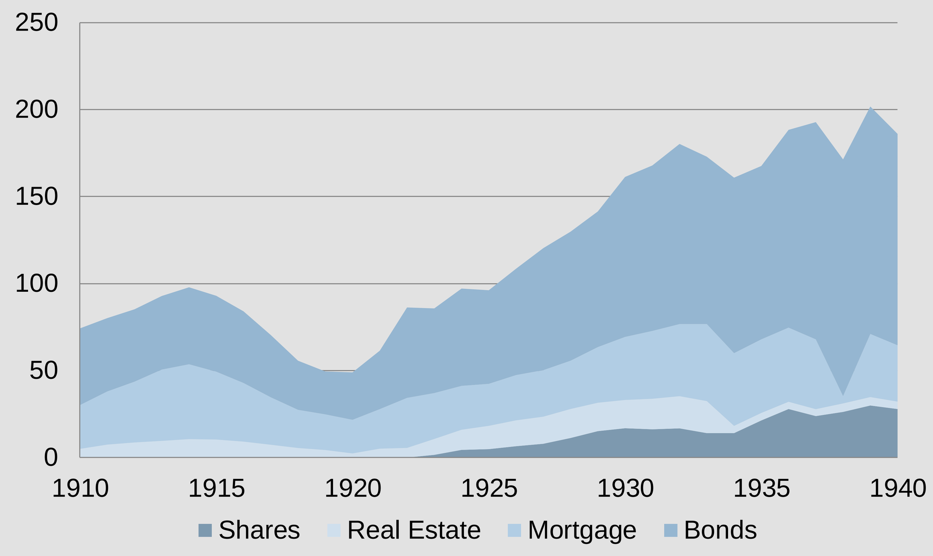


Fig. 3. Composition of portefeuille (in Mio. Swiss Francs, 1914=100)

4. Insider-related corporate governance
System of selective protectionism (registered share, restricted transferability) gave control mechanism to management. Shareholders consisted mostly of founding-families of the Swiss business elite. They abstained from full shareholder value, received a stable dividend, followed a long-term investment strategy, were profiting from various capital increases paid for by hidden reserves, had a close personal relation and shared the same mentality. Additionally to sustain the insider-related corporate governance system for more than 40 years, the insurance company had a very insider-related recruitment policy.

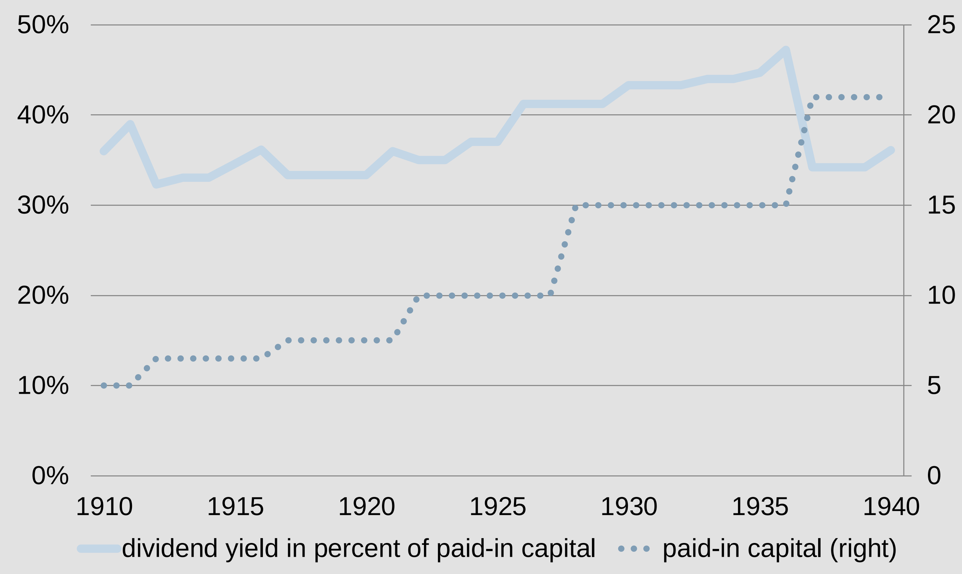


Fig. 4. Dividend yield in percent of paid-in capital (left) and paid-in capital (right) (in Mio. Swiss Francs)

4 Next steps

- To compare results with other major Swiss insurance companies that took advantage of booming stock markets in the 1920s and nearly went bankrupt.
- To identify deeper reasons for differing financial policy across the companies.
- To include in the analysis of corporate governance culture, collective knowledge, biographies, implicit procedures and informal power relations.

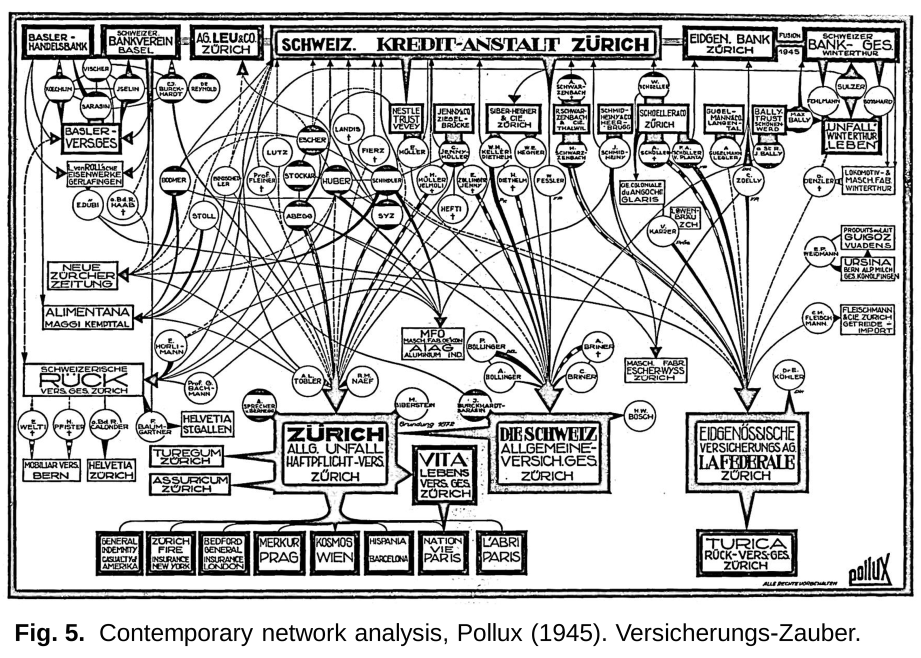


Fig. 5. Contemporary network analysis, Pollux (1945). Versicherungs-Zauber.

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CORPORATE ARCHIVES OF ZURICH INSURANCE COMPANY

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