

## Insurance oversight: managing complexity responsibly

Insurance is complex. Imagine how difficult it is to determine a fair and competitive premium rate for a white Toyota Corolla that is parked overnight outdoors, behind a gate and under cover, in Mangaung, and driven by a 38-year-old, mainly to work just outside of town, but occasionally for long drives on the weekend. What if the policyholder moves to Kempton Park? How much capital is required to safeguard the insurer's ability to pay claims on this and the other 350 000 cars that it insures? How should it invest this capital to balance policyholder security and shareholder return?

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Governance is the process that ensures that these and all other pertinent questions are soundly answered by the management team. The examples given scarcely scratch the surface. This piece considers how such oversight works in practice and asks whether the principles of expertise, integrity and independence also apply to governance in the context of insurance.

An insurer makes a promise to a policyholder. It takes upon itself a risk that its client cannot manage in return for a consideration, typically a monthly premium. Since the customer cannot be sure up front that the insurer has the means to make good on its promise, an insurer must meet a range of requirements to safeguard this commitment. These requirements are set out in law. They represent the minimum standards that the insurer must set—and stick to—if it wishes to retain its licence to sell insurance. It must retain its licence because selling such a promise without a licence is illegal.

One such legal requirement is the set of minimum standards of oversight. Much of this set is generic, common to all companies. The King Codes of Corporate Governance set out the general requirements of all boards. But regulation also sets out specific requirements of insurance oversight to protect the customers of these insurers. These will be covered in a later article. For now, the broad principles underpinning this governance are outlined.

### Responsibility matters

The Board is held accountable for leading an insurer. "I did not understand," is not an acceptable excuse by a director when something goes wrong. The board must establish the framework required to manage complex products and their associated operations and risks.

How does it do this? It puts in place a framework for exercising this authority. This framework explains how board oversight works in practice, how directors are elected, how the board delegates responsibility to management, what the limits of this delegation might be, how

it works with specialists that scrutinise the operations of the insurer and what it does to ensure that financial reports are correct and that available reserves are sufficient to pay claims when they are received. Again, this list represents just the beginning.

It is surely obvious, in the context of such complexity, that expertise matters. Since it is difficult for every director to be an expert, boards typically aim to ensure that, collectively, their members have the expertise required to exercise this oversight responsibly.

### Help is available

Boards cannot be expected to check every page of every document in the insurer to satisfy themselves that the entity is being soundly run. The directors depend on carefully selected managers to do this. These managers are also experts, though usually experts in a particular aspect of insurance management. Collectively, they may be described as the first line, more fully, the *first line of defence* against things going wrong.

Depending entirely on these managers is generally not considered sufficient. Help is contracted in three layers. The *second line of defence* is taken up by specialists in risk management and compliance. They make sure that those in the first line are identifying and managing organisational risk and running the company lawfully. The *third line* is the internal audit function, which checks on operational integrity and on the effectiveness of those in the second line. And the *fourth line* is occupied by the external auditor, which has a legal responsibility to ensure that the financial statements of the insurer present a true picture of its state, not a simple task.

While the board may depend to an extent on the experts in these four lines of defence, the directors cannot absolve themselves of their responsibility to exercise sound oversight of management and of the supporting experts. Their integrity matters, but so does their independence. They cannot be unduly swayed by management in exercising their duty of oversight.

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It is a brave man or woman who agrees to be a director of an insurer. The consequences of error can be disastrous. Careful attention to every element of the governance structure is required. Though experts are invited to assist them, directors must remain constantly vigilant. After all, the insurer's customers depend on this vigilance. **Rob Rusconi**