

# Crash Course in Corporate Governance

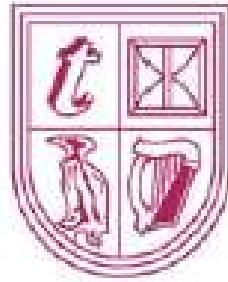
Presentation to Society of Actuaries in Ireland

James Maher MA FFA FSAI Dip CG  
Peter Oakes Solicitor Dip IoD Dip CG



# Crash Course in Corporate Governance

- Introduction
- Definitions, Principles and Concepts (JM)
- From Principles to Regulations (& Principles based regulations) (PO)
- Recent Developments (JM)
- Ireland Plc Issues & Considerations (PO)
- Q&A



# Background

Defining “Corporate Governance”

Moral Hazard

Corporate Governance & Prudential Regulation



# Defining Corporate Governance

- Regional Variations & Biases
  - Culture, Ownership, Legal Systems etc
  - In particular w.r.t. scope of Stakeholders
  - Academic Definitions V Legal Definitions
- Original/Early Definitions
  - “*System by which companies are directed and controlled*”
  - “*Process that deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*”
- Organisation for Economic Cooperation and Development
  - “***A set of relationships between a companies management, its board, its shareholders, and other stakeholders.***”
  - Pulled into Irish regulations via Corporate Governance Requirement for Reinsurers (2007)
  - OECD not to be confused with ODCE (Office of Director of Corporate Enforcement) who supervises application of company law



# OECD Principles of CG

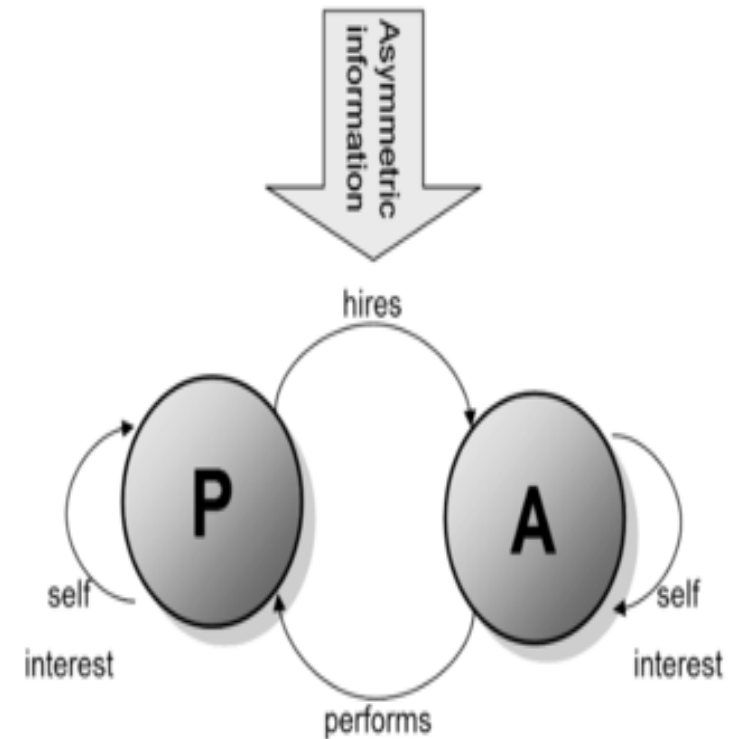
1. **Framework:** *Be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities*
2. **Shareholders:** *Protect and facilitate the exercise of s'holders rights*
3. **Equitable:** *Ensure the equitable treatment of all shareholders, including minority and foreign shareholders .....*
4. **Stakeholders:** *Recognise the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises*
5. **Transparency:** *Ensure that timely and accurate disclosure is made on all materials matters .....*
6. **Responsibility:** *Ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company **and** the shareholders*

*Extracted and Adapted from OECD Principles of Corporate Governance 2004*



# Moral Hazard & Principal-Agent

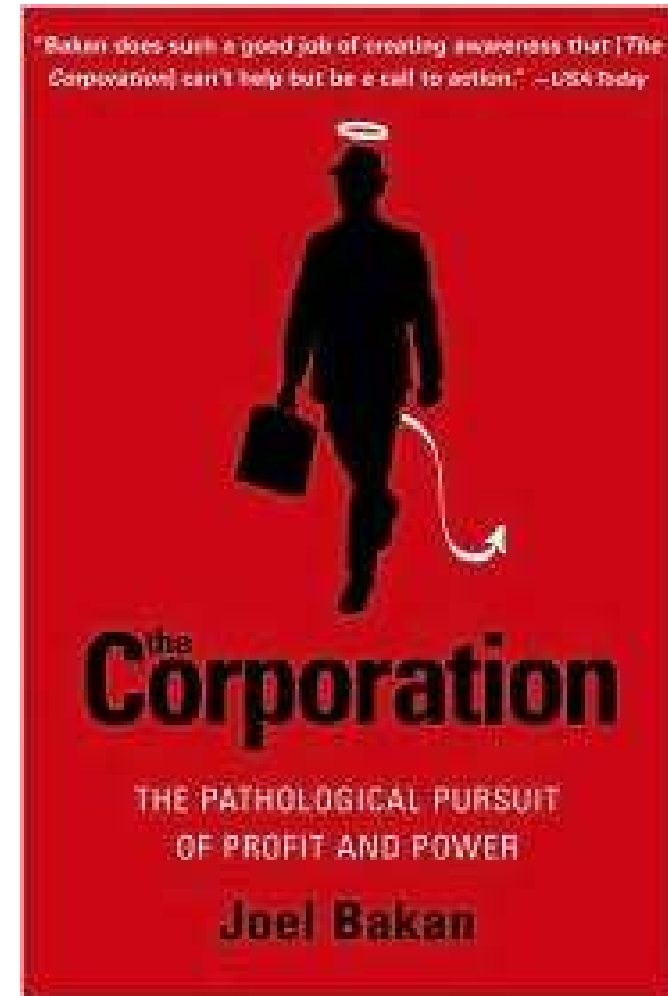
- Agency Theory => cost effective to allow a certain level of agency risk
- Agency risk lower down in the organisation ?
- Risks & Hegemony
  - Distributed Ownership
  - Insiders & Minorities
- Corporate Governance
  - Systems to intervene between Principal and Agent to manage the asymmetries





# Moral Hazard & Externalities

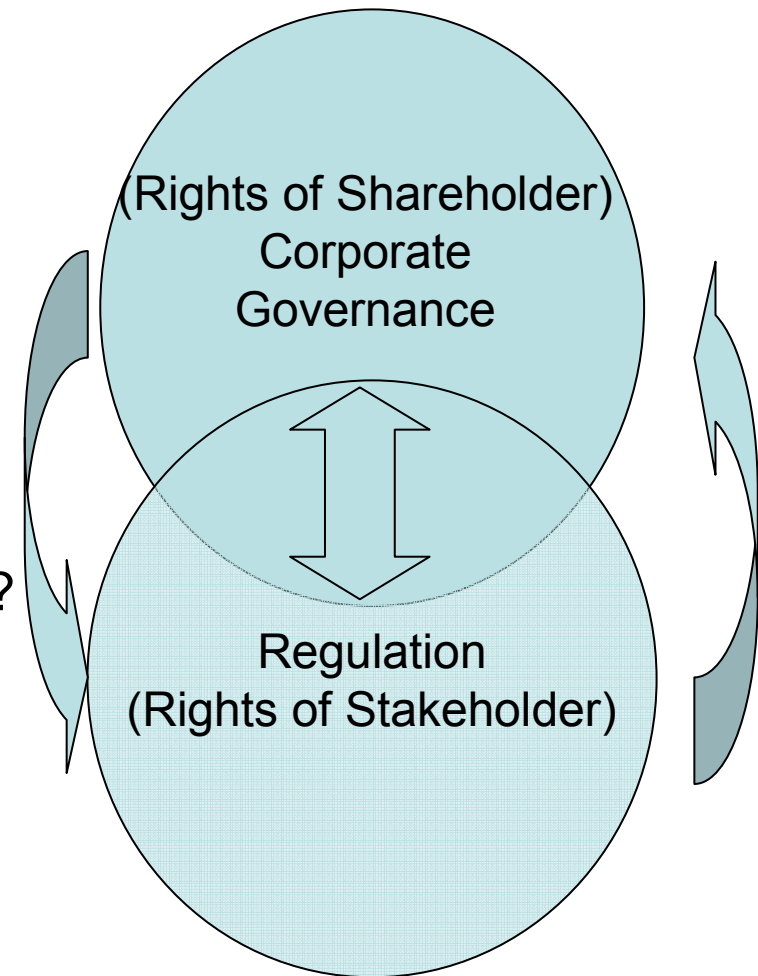
- Externalities :-
  - “an impact on a party that is not directly involved in a transaction”
  - E.g. Taxpayers picking up the bill for failed banks, Policyholders exposure to recovery risks etc
- Unchecked, corporation required to act solely in self interest
- Self Regulation/Rules of the Common ?
- Regulation (& Supervision) required
  - To reduce externalities
  - To ensure level playing field





# Moral Hazard & Financial Services

- CG => Shareholder Centric subject to legal rights of stakeholders
- Prudential Regulation => stakeholders not protected by co. law
- Market Regulation => Level playing field
- Choice of Jurisdiction for Shareholders ?
  - Agency Risk V Company Law/Listing
  - Regulation V Market Behaviour
  - Regulation V S/Holder return
- Ever Shifting Balance ?
  - Social & Political Zeitgeist
  - Predator Prey Model







# The role of financial models ?

- Misuse, misapplication and over reliance on models have arguably been a tool of the “Agents” in our current crisis
  - Models exclude undereducated directors fulfilling role
  - Models used to determine profit and capital => remuneration
- Can mathematical models be applied to governance ?
- Focus on People, Incentives, Responsibility, Oversight etc

~~On Dynamic Principal-Agent Problems in Continuous Time~~  
 Noah Williams\*  
 Department of Economics, University of Wisconsin - Madison  
 E-mail: nmwilliams@wisc.edu  
 Revised September 17, 2008

~~I study the provision of incentives in dynamic moral hazard models with hidden actions and possibly hidden states. I characterize implementable contracts by establishing the applicability of the first-order approach to contracting. Implementable contracts are history dependent, but can be written recursively with a small number of state variables. When the agent's actions are hidden, but all states are observed, implementable contracts must take account of the agent's utility process. When the agent has access to states which the principal cannot observe, implementable contracts must also take account of the shadow value (in marginal utility terms) of the hidden states. As an application of my results, I explicitly solve a model with linear production and exponential utility, showing how allocations are distorted for incentive reasons, and how access to hidden savings further alters allocations.~~

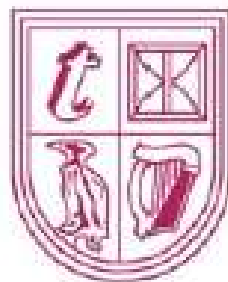
~~From the literature starting with Alchian, Pearce, and Stacchetti (1986)-(1990) and Spear Srivastava (1987), we know that in a dynamic moral hazard setting a contract must condition on the agent's promised utility. Here the promised utility process  $q_t$  is the role of the co-state. In particular, the co-state follows:~~

$$dq_t = -u(s_t, e_t^*)dt + \gamma_t \sigma dW_t, \quad q_T = v(s_T). \tag{5}$$

~~follows from the more general (17) below, and its solution can be expressed:~~

$$q_t = E \left[ \int_t^T u(s_t, e_t^*)dt + v(s_T) \middle| \mathcal{F}_t \right].$$

~~$q_t$  is the agent's optimal utility process, the remaining expected utility at date  $t$  when writing an optimal control  $e^*$ .  $\gamma_t$  gives the sensitivity of the agent's promised~~



# From Principles to Regulations (*& principles based regulations*)

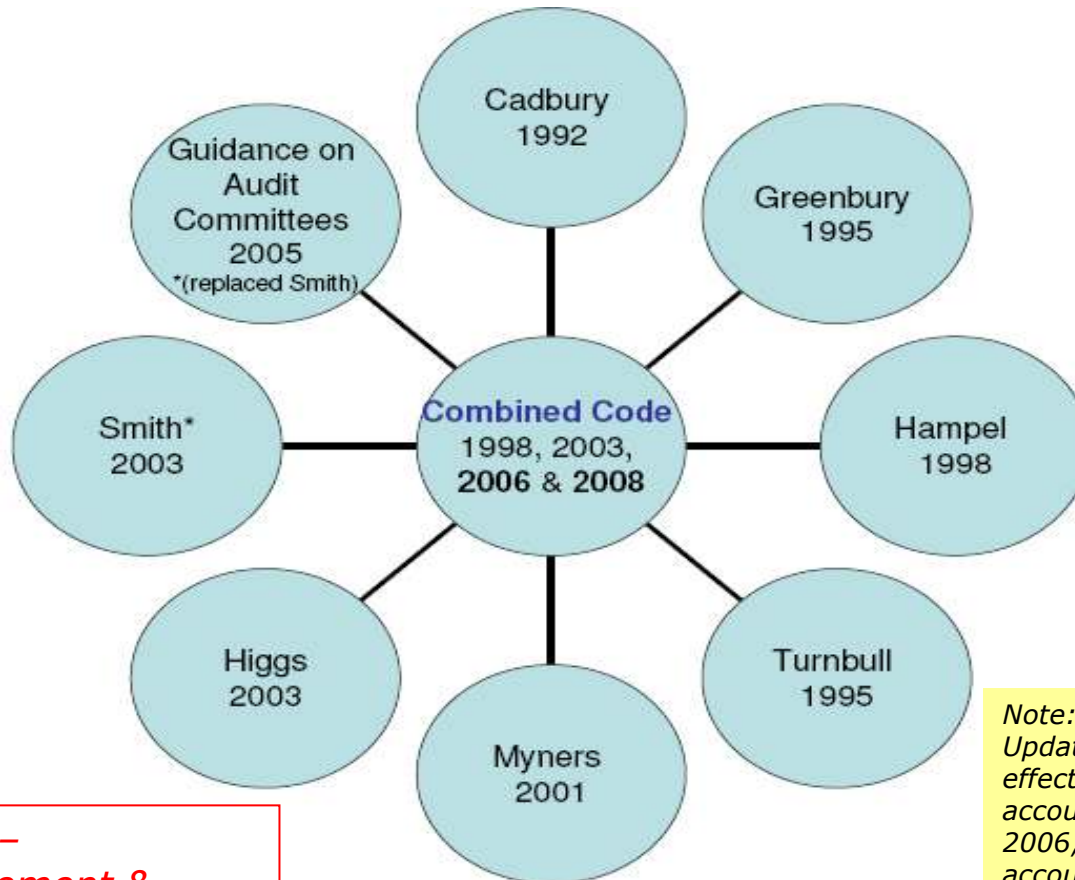
The Combined Code

Company Law

Some Financial Regulator & Insurance Issues



# Combined Code



*Financial Regulator –  
Fitness & Probity  
standards*

*ODCE –  
enforcement &  
compliance powers*

*Note: Combined Code issued in 1998. Updated regularly. Two versions are in effect (i) 2006 edition, applies to accounting periods from 1 November 2006; and (ii) June 2008 edition, applies to accounting periods from 29 June 2008.*

Responses to current review available  
[www.frc.org.uk](http://www.frc.org.uk)



# Combined Code

- Irish and UK plcs adopt the Code on a ‘comply or explain’ basis
- Departures are not prohibited but should be justified
  - *known as the ‘comply or explain’ regime*
- The Code provides, amongst other things, a high level blue print for the standards of Directors (especially NEDs)
- Main Principles are supported by *Supporting Principles* and *Code Provisions*

*Note: The Financial Regulator uses the Combined Code as an informal benchmark vis-à-vis non plc regulated entities*



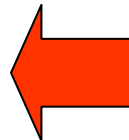
# Directors 'oath of office': regulated entities (1/2)

FINANCIAL REGULATOR  
*Rialtóir Airgeadais*

Name of Applicant	
Proposed Position	
Name of Proposing Entity	

Individual Questionnaire

December 2008



## DECLARATION TO BE COMPLETED WHERE THE PROPOSED APPLICANT IS A PROPOSED DIRECTOR OF THE PROPOSING ENTITY

### DECLARATION

I, ..... (*name of individual*) declare that:

- (i) I am fully aware of the obligations and the duties of a director of a company under the Companies Acts 1963 to 2003 as amended.
- (ii) I hereby confirm my awareness of my responsibilities arising from the legislation, regulations, codes of practice, guidance notes, guidelines and any other rules or directives, which are of relevance to the proposed position and I confirm my intention to ensure that the proposing entity of which I am to be a Director will be run in compliance with the same.

Dated this ..... day of ..... 20.....

Signed: .....

Position/Proposed Position: .....



# Directors 'oath of office': regulated entities (2/2)

**DECLARATION TO BE COMPLETED WHERE  
THE PROPOSED APPLICANT IS A  
PROPOSED DIRECTOR OF THE  
PROPOSING ENTITY**

DECLARATION

I, ..... (name of individual) declare that:

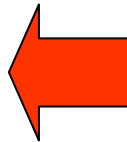
(i) I am fully aware of the obligations and the duties of a director of a company under the Companies Acts 1963 to 2003 as amended.

(ii) I hereby confirm my awareness of my responsibilities arising from the legislation, regulations, codes of practice, guidance notes, guidelines and any other rules or directives, which are of relevance to the proposed position and I confirm my intention to ensure that the proposing entity of which I am to be a Director will be run in compliance with the same.

Date: this day of 20

Signed:

Position/Proposed Position:



- (i) I am fully aware of the obligations and the duties of a director of a company under the Companies Acts 1963 to 2003 as amended.
- (ii) I hereby confirm my awareness of my responsibilities arising from the legislation, regulations, codes of practice, guidance notes, guidelines and any other rules or directives, which are of **relevance** to the proposed position and I confirm my intention to ensure that the proposing entity of which I am to be a Director will be run in compliance with the same.



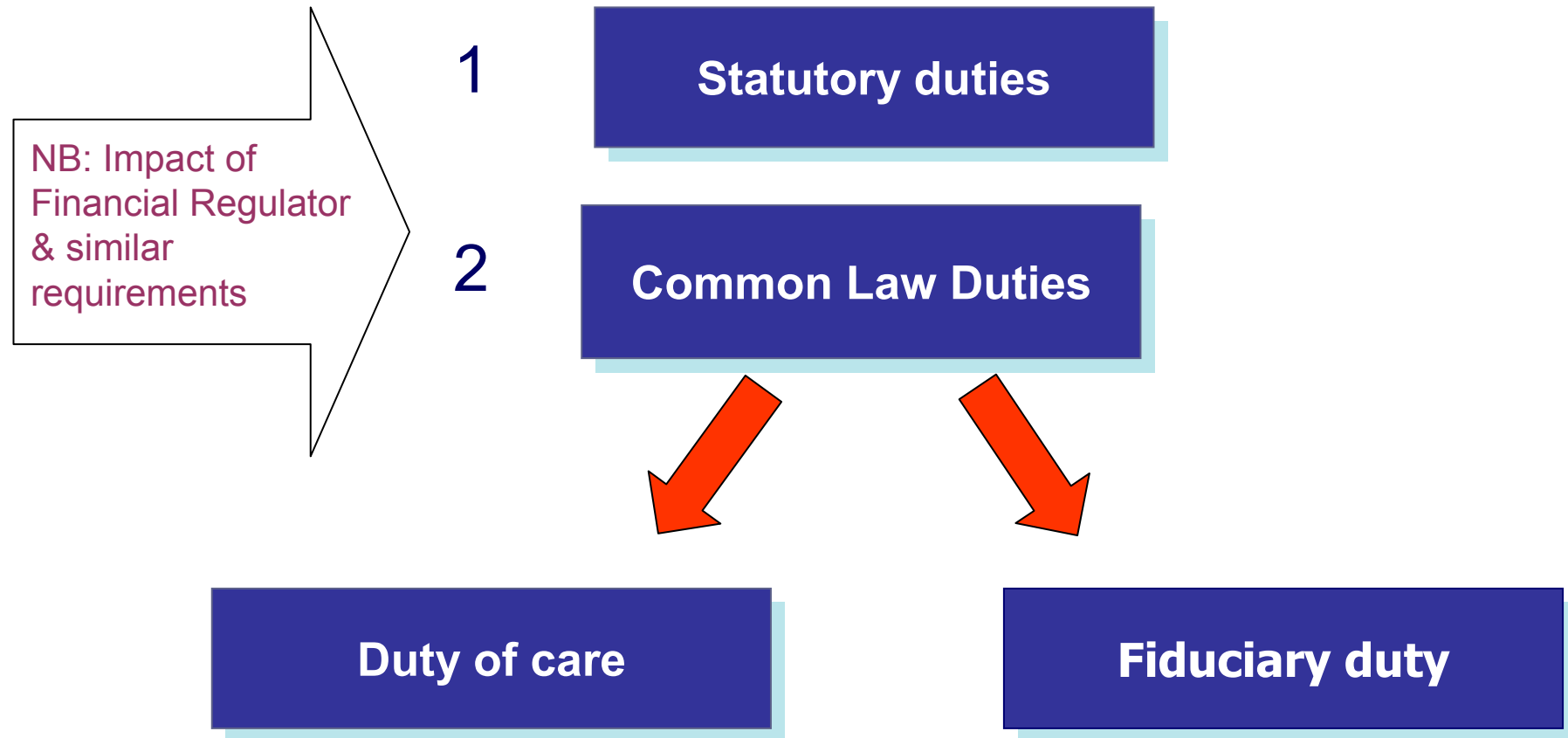
# Companies Act 1990 – sec 383

*[by s.100 Company Law Enforcement Act 2001]*

- 383.—(1) For the purpose of any provision of the Companies Acts which provides that an officer of a company who is in default shall be liable to a fine or penalty, *an officer who is in default is any officer who authorises or who, in breach of his duty as such officer, permits, the default mentioned in the provision.*
- (2) For the purposes of this section, *an officer shall be presumed to have permitted a default by the company unless the officer can establish that he took all reasonable steps to prevent it or that, by reason of circumstances beyond his control, was unable to do so.*
- (3) It is the duty of each director and secretary of a company to ensure that the requirements of the Companies Acts are complied with by the company.
- (4) In this section ‘default’ includes a refusal or contravention.”.
- In short, it is the director’s/officer’s duty to ensure company law is complied with (so you have to know it) and such person can be guilty if found wanting where their default leads to a breach by the company



# Directors duties - overview







# A ‘*director is a director is a director*’: Some types

**Shadow Director** – any person with whose instructions the Directors of the company normally comply is a ‘shadow director’

**Alternate Director** – can only be appointed with the agreement of a majority of the directors.

**Executive Directors** – are involved in the day to day management of the company, e.g. finance/marketing/managing director etc.

**Non-Executive Directors** - are not involved in the day to day management of the company, they can bring an independent voice and perspective to the board.

**De Facto Director** – a person who has not been validly appointed or who is disqualified but who in effect acts as if a director. These persons fall under Section 2 (1) of the 1963 Act.



# Director's Responsibilities

**Section 12 (1) (b) Company Law Enforcement Act 2001: function of a Director is *“to encourage compliance with the Companies Acts”*.**

**Section 2 (1) of the Companies Act 1963 defines a ‘director’ as including any *“person occupying the position of director by whatever name called”***

**The main law relating to Directors:**

- **sections 174 to 199 of the Companies Act, 1963,**
- **Parts III, IV (Chapter 1 only) and**
- **VII of the Companies Act, 1990,**
- **sections 43 to 45 of the Company Law (Amendment) (No. 2) Act, 1999 and**
- **Parts 4 and 9 of the Company Law Enforcement Act, 2001.**



# General duties

- Duties of a Director are owed to the company
- Act in good faith and in company's interest
- Open and transparent
- Act with due care, skill and diligence
- To comply personally and ensure that the company complies with the law



# Accounting and Fiduciary Duties

## Duty to act bona fide

**Directors must act in good faith in interests of company as a whole**

**Cannot act in interests of a section of the members**

**Cannot act only on short-term interests without regard to long-term interests**

 ***Clark v Workman [1920] 1 IR 107***

In this case, the Directors gave an undertaking to a third party to look after his interests, and were found to have acted improperly.

When looking at whether the Director's powers were exercised in good faith, it is useful to consider the intention(s) of the Director and the proper purpose of the powers exercised.

A Director must not agree to restrict his power to exercise an independent judgement.

 ***Fulham Football Club Ltd et al v Cabra Estates PLC [1994] 1 BCLC 363***



# Disclosure Requirements

## Duty of Disclosure

Personal details for the register of Directors

Interests in shares for the register of interests

Payments in connection with share transfers

Directors' service contracts

Interests in company contracts or proposals, etc.

## Curbs on use by Director of Company Assets

General prohibition applies (with exceptions)

🚨 **Major area of non-compliance**

📖 **Office of the Director of Corporate Enforcement Guidance**

**'Transactions Involving Directors' Book**

•Source – Office of the Director of Corporate Enforcement





# Insolvency

## Duty to act responsibly in insolvent situations

1. Cease trading in a timely manner
2. Preserve company assets
3. Make an accurate statement of company affairs
4. Co-operate with any appointed liquidator

## Fraudulent Trading

*person knowingly a party to the carrying on of any business of company with intent to defraud its creditors or for any fraudulent purpose.*

**Court is empowered to make a Director personally liable for the company's liabilities.**

**A Director found guilty of fraudulent trading can be liable to either imprisonment for up to seven years and/or fines of up to €63,480**



# Reckless Trading

*A person can be held personally liable for the debts of a company if, while a Director of the company the person was knowingly a party to the carrying on of the business in a reckless manner or with intent to defraud its creditors*

**A liquidator, receiver, examiner or creditor may apply to Court to have a Director held personally liable for debts.**

**A Directors may be deemed to be knowingly a party to reckless trading where**

- (a) Having regard to the general knowledge, skill and experience that might be reasonably expected of a person in that position, he ought to have known that his actions or those of the company would cause loss to the creditors; or**
- (b) If the Director was party to the company contracting a debt and did not honestly believe on reasonable grounds that the company would be able to repay the debt.**



# Consequences

- **Personal Liability**
  - losses resulting from illegal acts
  - acting beyond your powers,
  - failing to use sufficient skill and care.
  - for company debts
- **Companies Act 1990**
  - Restriction
  - Disqualification
- **Penalties under CBFSAI Act**





# What is a director to do now?

*The following are some suggestions for non-executive directors who wish to ensure they would be able to show they adequately supervised and controlled the affairs of the company:*

- I. Attend all board meetings
- II. Ensure that attendance and all contributions to the meeting are duly noted
- III. Ensure board packs are received well in advance of the meetings
- IV. If board meetings are not being held on a regular basis, write to the executive directors seeking explanations and pursue in writing.  
*Any reasons offered for lack of board meetings should be considered carefully*
- I. Maintain and document all contact with both executive and non-executive fellow directors on an ongoing basis
- II. Ensure up-to-date and accurate financial information is being received on a regular basis
- III. Ensure there is adequate supervision of those individuals to whom functions of the board have been delegated
- IV. If on the board to give the benefit of a certain skill or expertise ensure that any contributions in this regard are duly noted in minutes of relevant meetings
- V. Upon resignation, ensure it is duly noted in the company records and in Companies House as soon as possible.



# Extension of General Duties by Financial Regulator (1/2)

## Fitness

- expected to remain competent for positions held
- May be achieved through CPD regime
  - Firms to ensure that approved persons meet CPD requirements

## Probity

- not just at the moment of appointment
- Approved Persons and others to adhere to firm's internal code of ethical behaviour.
- Code is required:
  - to cover guidelines on behaviour re misuse of systems/processes for unethical purposes (e.g. attempts to facilitate fraud, money laundering or tax evasion)
  - serious breaches to be recorded, including disciplinary action taken
  - where an approved person is involved, firm must immediately notify Financial Regulator



# Extension of General Duties by Financial Regulator (2/2)

- Firms must foster a system that supports continuing adherence to the values underlying probity.
- Firms are responsible for adopting policies and processes that detect instances where ethical behaviour is under threat, e.g.
  - an individual Director or Manager acts with scrupulous honesty but if becomes aware of unethical or dishonest behaviour on the part of a colleague and fails to act to stop it, that reflects on his/her honesty.
  - a Director or senior Manager who directs a junior colleague to act in an unethical or dishonest manner is failing to act ethically, fairly and with a proper commitment to compliance
- Where such instances arise, the firm should discipline and report same immediately to Financial Regulator



# Compliance Function: DETE Guidelines 2001

- Each insurance undertaking must appoint a compliance officer
- Responsibility for ongoing monitoring of firm's compliance with regulatory requirements.
- Functions include:
  - Obtain CEO & Board approval of a compliance policy statement
  - Monitor compliance & report to the CEO & Board
  - Review products, procedures and systems on a planned basis & advise on compliance steps
- NB: Appointment of Compliance Officer supplements – *not supplants* – Board's responsibility
- Available at [www.ifsra.ie](http://www.ifsra.ie)

## GUIDELINES FOR INSURANCE COMPANIES: APPOINTMENT OF A COMPLIANCE OFFICER

Insurance Financial Supervision Section

*Department of Enterprise, Trade & Employment*

*July 2001*



# Compliance Function: Consumer Protection Code

- Chapter 2, paras 57-60 (underpinned by General Principles) requires:
  - firms to demonstrate that policies and procedures facilitate compliance with Code
  - provide information which is full, fair & accurate in all respects / not mislead IFSRA
  - provide IFSRA with records evidencing compliance with the Code for a period of up to (a maximum) period of 6 years.



# Compliance Function: Reinsurance Requirements



***NB: Reinsurance Firms Only***

Copyright Maher & Oakes  
September 2009



# Requirements

- Approach
- Hearts & Minds
- Board of Directors
- Independent Non Executive Directors
- Internal Controls
- Audit Function
- Compliance Function
- Senior Management



# Solvency II Requirements ?

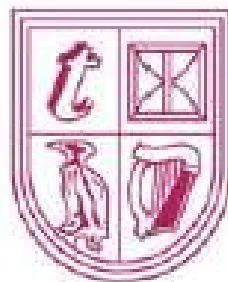
- If you work in compliance in insurance you will have to read the Solvency II Directive
  - “there is no easy way around that other than putting a cold towel over your head and reading it [MiFID] and getting to know what’s in the Directive itself” Con Horan, Prudential Director, Financial Regulator (Finance Magazine January 2007).

- Implementation – 2012



Con Horan





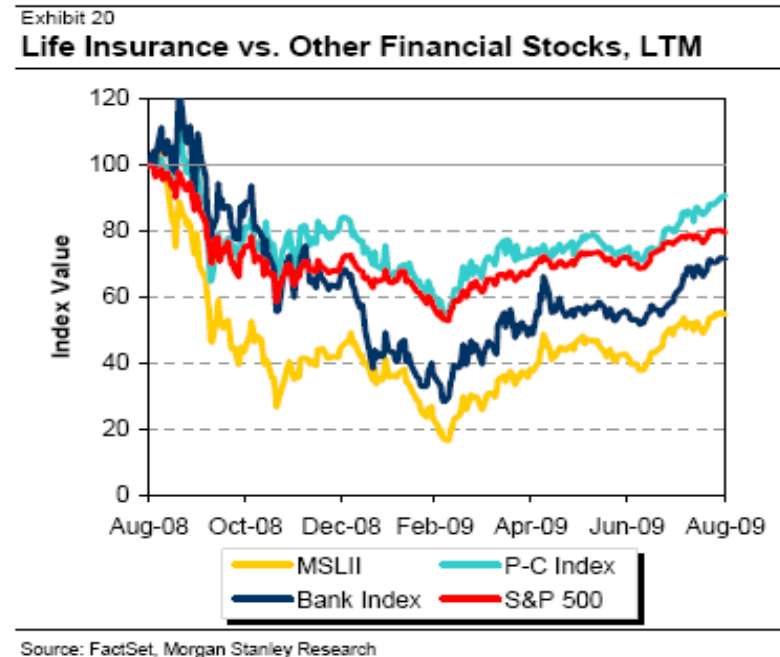
# Recent Developments

Not just a Banking crisis  
Analysis and Response to Crisis  
Solvency II



# The Crisis

- Banking Sector
- Insurance Sectors
  - Failures & Bailouts
    - Monolines, US Life Co's, AIG
  - Recapitalisations
  - Private Provision
    - loss of private savings
    - cost of annuitisation
- Integrated Response
  - Across Sectors
  - Across Geographies





# Analysis and Response

- 3 Wise Men

- Jacques de Laroisiere (Direct impact on CEIOPS)
- Turner (UK Bank Regulation )
- Walker (Listed Banks & Life Insurers)



- The Rest of Us (Actuarial Community)

- IAA – Advisory Task Force on Risk Crisis
- UK Profession Global Financial Crisis Forum MIG
- “Systemic Risk in Financial Services” CASS Business School
- “Some Thoughts on Risk & Regulation” Jimmy Joyce
- Many working parties.....





# The Crisis and Solvency II

- Group Diversification
- Swaps
- Reliable Replicability
- Counterparty Default
- etc





# Solvency II & Corporate Governance

- Level 1 Text

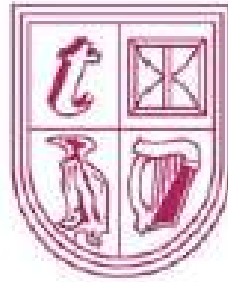
Article	Title/Subject
41	General Governance Requirement
42	Fit and Proper
43	Risk Management System
45	Internal Control
46	Internal Audit
47	Actuarial Function
48	Outsourcing

- Level 2

- CP 33 Systems of Governance (Closed in June)
- CP 59 Advice on Remuneration (Closes 11<sup>th</sup> of September)

- Feedback available for review

- Perspective of different stakeholders



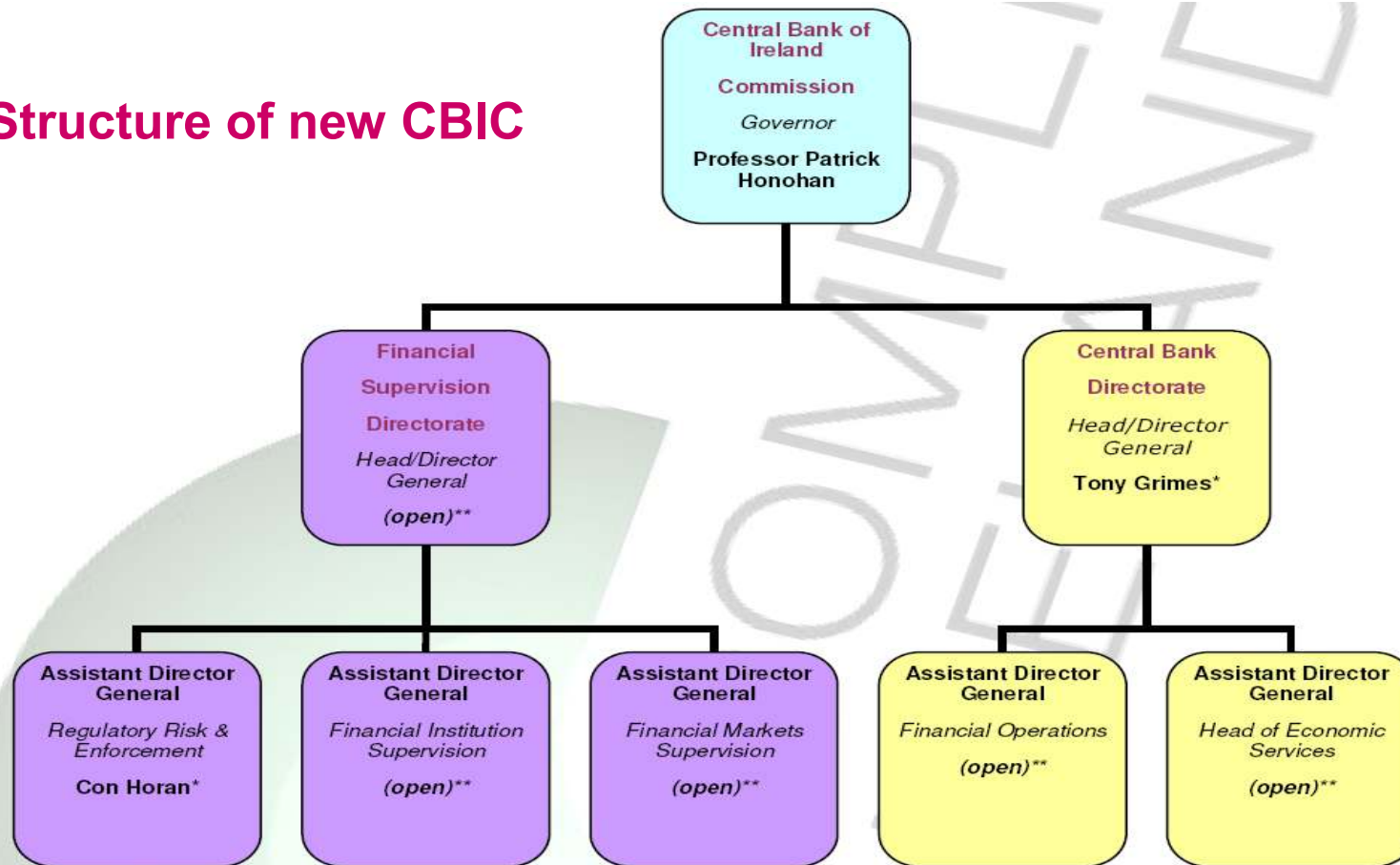
# Ireland Plc Issues & Considerations

Tentative Observations on Regulation  
Capital Raising & International Reputation  
A Land of Captives and Subsidiaries ?



# Tentative Observations on Regulation

## Structure of new CBIC



\* Con Horan and Tony Grimes were named to these positions in the Irish Times on Saturday 27 June 2009.

\*\* the positions marked open are those advertised on the Central Bank's and Financial Regulator's websites today, with the exception of the ADG Financial Markets Supervision role.



# Tentative Observations on Regulation

- Accepted that regulation fundamentally failed
- Failure due to Regulatory:
  - Model?
  - Process?
  - People?
    - regulators?
    - regulated?
- Ireland likely to lose the opportunity to answer these questions with the rush to NAMA and new CBIC
- At risk of swing too far towards a rules-based regime?
  - *would that be a bad thing?*
- Cost of Solvency II
  - ABI urges British Treasurer & European Commission to intervene over a threat *"to the industry, to its customers and even to financial stability"*.



*'Fears over conservatism of Solvency II rules'*, FT.com 02/09/2009





# Capital Raising

- National Debt
  - €69,290million (NTMA)
  - Success of NTMA auctions to date
- Private Sector
  - *“There is also the so-called “wall of worry”, which refers to the fact that Irish banks will have to redeem or roll over 30% of all their bonds next year. This will be difficult regardless of Nama, but any notion in the next few months of an urge to default might make it impossible.”*

*‘The Bondholders Cometh’*, Sunday Tribune, 06/09/2009



# International Reputation (1/2)

And the lesson of Ireland is that you really, really don't want to put yourself in a position where you have to punish your economy in order to save your banks.

- © *New York Times*, 19 April 2009, Paul Krugman  
(*Erin Go Broke*)

One message of this bail-out is that the Irish bank executive self-preservation society has scored another success - jobs have been kept and state control avoided. The best way to end the banks' misery would be to nationalise the pair. Once more with feeling please, Dublin.

- © *Financial Times*, 13 February 2009, Lex Column  
(*Irish Bank Bail-out 2.0*)



## International Reputation (2/2)

**Anglo Irish Bank**, Ireland's most reckless commercial property lender, has at last been committed to the safety of an institution: the Irish government. Dublin procrastinated as Anglo Irish gasped its last, the **chairman resigned over governance lapses** and risks grew of a dangerous run on the bank. **Full nationalisation fast became the only option** to avert a collapse of the Irish banking system.

Bank of Ireland and Allied Irish Banks may be marginally safer bets now that the government has removed the sector's main systemic risk. Time, then, for Ireland's cosy coterie of bankers and politicians to resume discussion of their golf handicaps in the club bars. But not for too long: neither bank has a price/earnings ratio of more than one, which speaks volumes about investor confidence in the sector's prospects.

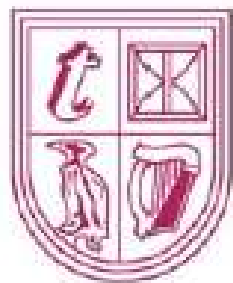
*© Financial Times, 16 January 2009, Lex Column  
(Irish Banks)*



# Captives and Subsidiaries ?

- What is Ireland's calling?
  - Substantial Insurance Presence
  - Captives and Subsidiaries
- Ireland could become the European centre location of Insurance
  - *'Ireland ticks all boxes for Zurich chief'*, Sunday Times, Business section p6 6/09/2009 (interview with Markus Hongler, CEO Zurich Ireland plc)
- Other Opportunities
  - S&P/PWC – Bermudan Reinsurers seeking a Euro-zone domicile => An Opportunity for Ireland
  - Solvency II – Regulatory Excellence





# Thank You

## Q&A