THE SOCIETY OF ACTUARIES IN IRELAND

Submission on the Financial Regulator's Consultation Paper on

"Corporate Governance Requirements for Credit Institutions and Insurance Undertakings" (CP41)

June 2010

The Society of Actuaries in Ireland

The Society of Actuaries in Ireland is the professional body representing the actuarial profession in Ireland. Many of our members hold responsible roles within or as advisers to financial services firms. They act as Board members, Appointed Actuaries (with statutory responsibilities), Signing Actuaries (also with statutory responsibilities), and senior managers carrying a range of responsibilities including financial and risk management.

In addition, the Society is an active member of the Groupe Consultatif Actuariel Europeen and is fully engaged in the Groupe's ongoing work on governance systems and prudential regulatory standards, especially in relation to the development of Solvency II.

Introduction

The Society welcomes the opportunity to participate in this consultation on "Corporate Governance Requirements for Credit Institutions and Insurance Undertakings" ("The Requirements"). We fully endorse the Financial Regulator's view that enhancement of corporate governance along with more demanding regulatory requirements and improved risk management are required in order to improve the resilience of the Irish financial services sector to future crises.

We believe that many of The Requirements will contribute to more effective corporate governance for many institutions and we welcome the requirements to:

- document Board and other responsibilities clearly;
- establish an appropriate balance between executive and non-executive Directors;
- ensure there is an appropriate representation of independent views on the Board;
- document the institution's risk appetite; and
- establish effective risk management processes and risk oversight systems.

We welcome the requirement to include both quantitative metrics and qualitative terms in the expression of risk appetite. We believe that the quantification of risk in many areas facilitates and aids management and mitigation of those risks.

In responding to this consultation, we have sought to separate out some "high level themes" that are recurrent throughout our detailed response to the consultation paper and we summarise and explain our views on these themes below.

High Level Themes

1. Primacy of Prudential Regulation in Stakeholder Protection

The "OECD Principles of Corporate Governance" outline the role of the Board and its responsibilities. The annotations to these principles state that:

> *"The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests."*

The annotations also recognise the Board's responsibilities to other stakeholders:

> *"In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities."*

Notwithstanding this, the reality of responsibilities to shareholders can introduce agency risk and externalities as to depositors, policyholders and, in the case of systemic risk, the wider group of taxpayers and citizens.

In this, the appropriate counterforce is direct regulation, with respect to all aspects of consumer protection and prudential supervision, to ensure that this wider stakeholder group is protected appropriately.

Appropriate systems of governance are a precondition to effective regulation, but they are not a substitute for direct prudential regulation and supervision. It is important to recognise the limitations of any governance system, arising from the inherent tension that often exists between the Board's responsibilities to shareholders and its responsibilities to other stakeholders. Thus, both corporate governance, exercised by the Board, and prudential oversight, exercised by the Financial Regulator, are essential.

The global financial crisis has highlighted the risks inherent in misalignment of the interests of shareholders and management on the one hand and bond-holders and depositors (and the Government as the provider of backstop guarantees) on the other hand. We suggest that prudential oversight could be significantly strengthened through an increased focus on agency risk within institutions in the supervisory processes. These processes must reflect the fact that the role of the supervisory authority increases in importance where the institution presents systemic risk.

2. Proportionate Application

In implementing The Requirements, regard needs to be paid to the nature of the institution. Institutions that pose significant stakeholder risk, and in particular those that pose significant systemic risk, should be subject to onerous obligations to implement and demonstrate compliance with the highest standards of governance as articulated in The Requirements.

Those organisations that pose lower levels of stakeholder/systemic risk should be subject to a lower level of requirements. Proportionate implementation is mentioned in The Requirements. However, there is a lack of clarity as to the extent of flexibility or proportionality permitted. Consequently, there is confusion as to what, in effect, the minimum requirements are for such institutions. Moreover, we are concerned that, if prior regulatory approval of exemptions is required, this will be unwieldy and will create uncertainty and practical problems and the risk of inconsistent treatment.

Within Ireland, there are many institutions that would not fall within any definition of "major institution", and a much smaller number that fully meet the definition of posing substantial stakeholder and systemic risk.

We believe that any minimum requirements proposed should be framed such that they are appropriate to the majority of institutions and specific higher standards should be demanded of the "major institutions".

We also believe that corporate governance should not be reduced to a mere compliance exercise and therefore the proposals should be underpinned by general principles that all Boards would be expected to observe.

A principles-based code supported by detailed provisions (as per the UK Corporate Governance Code and the FSA's prudential codes) may also be more appropriate to the diverse nature of the market and its heterogeneous mix of businesses and risk profiles.

Such an approach could be supported by a "comply or explain" regime, as is envisaged by the recent Green Paper on Corporate Governance from the European Commission.

3. Independence, Expertise and Substance over Form

We note that the Financial Regulator proposes to issue a revised fitness and probity framework in due course. However, the issue interacts to a certain extent with the proposed requirements as to Board composition. In this regard, we believe that there is scope for flexibility as to the balance of Board composition between *independence* and *experience* and the focus should be to ensure that there is a proper functioning Board in aggregate.

As an example, in the case of subsidiaries within a group of companies, it is arguable that the imposition of the proposed independence requirement on the Chairman may reduce rather than enhance the proper functioning of the Board. The requirement as proposed would exclude the possibility of a group employee filling the role, despite having greater knowledge of the group decision-making process and group strategy than an external candidate. Furthermore, within a group construct, and particularly if strategy is determined at group level, there are de facto limits to the effect and power of an Independent Chairman at a subsidiary level and thus such an imposition may well deliver an illusory form of governance without altering the substance of how the entity is governed. The focus should be on ensuring ongoing independence of mind, and likewise in relation to independent directors more generally.

As regards limits on the number of directorships that an individual may hold, the demands on a director's time are entirely company- specific and the time that a director has available will vary from individual to individual. As such, we do not see that there is necessarily a benefit in imposing strict limits on the number of directorships for other than "major institutions". Limits based on time commitments would be more effective. We believe that there is a value in requiring both directors and Boards to consider and articulate the time demands of the role and to justify the extent to which they have sufficient time available to meet those demands.

That said, we recognise that holding multiple directorships can create other material issues, including conflicts of interest. Requirement 4.10 provides that a director may not be appointed where "possible conflicts of interest may emerge which are significant to the overall work of the Board". However, The Requirements need to be strengthened to address more comprehensively how directors and Boards should deal with conflicts of interest where the possibility or fact of the conflict emerges after the director is appointed.

4. Timing and Consistency with International Developments

As noted in The Requirements, there has been a significant amount of research in recent times as to the causes and contributions to the financial crisis. Such analyses are currently taking effect through revised requirements in company law, listing requirements and, as is the case here, prudential requirements.

We believe that consistency with international developments would be an appropriate aim of The Requirements. In particular, Solvency II will take effect from end 2012 and will seek to achieve maximum harmonisation across Europe. The recent Green Paper on Corporate Governance from the European Commission gives some insight into potential developments at the European level.

As to the timing of implementing The Requirements, we endorse the fast-track approach to implementing an appropriate set of minimum standards, in particular in sectors of industry which do not already have such standards. However, we have some concerns regarding the fast-track implementation of a set of standards containing minimum requirements that might be disproportionate (and unclear) for many institutions.

Detailed comments

In the Appendix, we set out detailed comments on specific aspects of the proposed requirements, which reflect the above high-level themes.

Appendix

Specific comments on CP41; "Corporate Governance Requirements for Credit Institutions and Insurance Undertakings		
Reference	**Page no**	**Comment**
Introductory comments		
Proposal	2	
1.1	2	The causes of the international financial crisis were varied and recognisably included failures in corporate governance. Implementing tools and requirements to better align stakeholder interests and to ensure an appropriate focus on long term outcomes and performance is appropriate as part of an overall agenda for improving the stability and proper functioning of the financial sector.
1.2	2	It is appropriate to identify that the proposed governance requirements are requirements of the regulatory regime and extend or complement existing requirements under company law and listing requirements. The scope of these extensions could usefully be reviewed in the context of these wider elements to ensure congruence and consistency. Specific requirements should have regard to existing requirements under company law, listing requirements and existing prudential requirements and furthermore should have regard to the timing and scope of planned future changes. The Solvency II approach to similar issues is currently the subject of consultation. Any requirements introduced should be consistent with those proposed for Solvency II.
1.3	2	The Society of Actuaries in Ireland ("the Society") wholly endorses the Financial Regulator's intention to set and supervise standards of fitness and probity. In reviewing remuneration, the Society would propose that any such requirements are set in the context of agency theory and in particular seek to establish limitations only where inappropriate practices can lead to destabilising effects that are not addressed through other governance systems.
1.4	2	The minimum standards set out in the paper appear to be aimed at a "major institution" as defined. The majority of institutions in Ireland do not fall into this category and the requirements as set down may be disproportionate in many of these cases. A principles-based code supported by detailed provisions (as per the UK Corporate Governance Code and the FSA's prudential codes) may be more appropriate to the nature of the market. Similarly, the Regling Watson report into the crisis in the Irish banking system found that there is a case for principles-based supervision, in conjunction with clear rules. Such approaches could be supported by a "comply or explain" regime as is envisaged by these regimes and the more recent Green Paper on Corporate Governance from the EC. Compliance or otherwise with these principles and provisions can then be implemented and monitored through a combination of Pillar 2 oversight and Pillar 3 disclosures, as envisaged by the Financial Regulator as part of the wider Solvency II regime. If minimum rules are to be introduced, they should take consideration of the risk profiles of the various institutions and the extent of their systemic importance.

2.0 Legal Basis	3	
2.1	3	The scope of The Requirements should not be bounded by legal form but by the risk profile of the institution. That said, we understand the need to ground the requirements in a legal basis, thus the need for the listing here. As a specific comment, we understand that the Financial Regulator intends to include reinsurance undertakings covered by SI 380 into scope but we note that these are not listed in these requirements. In this regard, it is perhaps useful to note that there are separate corporate governance requirements that were specifically prepared and designed for reinsurance undertakings through CP18 and the subsequent requirements. The CP18 requirements are broadly consistent with the requirements proposed by CP41 and allow for a proportionate application that may not be possible under the proposed regime.
6.0 Consultation Process	5	
6.2	5	The costs of changes to governance systems encompass direct and indirect costs. We believe the indirect costs may potentially be the more significant and that these should be taken into account appropriately in any cost/benefit analyses. Direct costs will include items such as: ➢ Increased director fees arising from an increase in the number of directors, the expectations of the directors and, within a market context, the rate required by directors to service this demand; ➢ Meetings will give rise to explicit additional charges for travel, accommodation and hosting; ➢ Insurance costs will likely be directly impacted to cater to the increased number of directors and the directors' exposure in respect of specific responsibilities; and ➢ Management preparation and administrative support to the Board meetings. Indirect costs could include: ➢ Weakening of Board coherence and operation due to increased focus on independence over balance and experience; ➢ Weakening of shareholder support due to perceived dilution of parental recognition for international groups; ➢ Inappropriate attention to the appearance of compliance rather than the substance; and ➢ Confusion over the balance of obligation due to shareholders and stakeholders
6.3	6	We would agree with the different nature of captive insurers and consequent different treatment. That said, there are many attributes and risk profiles to undertakings that support a proportionate response. Thus, singling out one group, while welcome for that group, would not be welcomed if it determined the extent or limit to which proportionate application would be considered.
Consultation items		
1.0 Background	9	
1.1	9	We support the principle behind a more prescriptive regime for governance. However, there is a need for an evaluation of substance over form. Many of The Requirements as specified are clear in their intention but do not of themselves necessarily lead to good governance. The Requirements will only translate into good governance in practice if the right personnel, with the right incentives and the right level of training, are recruited onto Boards and if sufficient application and challenge are brought to the table proactively by all directors. The Financial Regulator could consider introducing an additional requirement for director interviews for major institutions to provide assurance on this point.

1.3	9	We note there has been a significant amount of development in corporate governance policy and research based on the financial crisis and that the majority of the findings have been mutually reinforcing as to the requirements of corporate governance. We additionally note that the preponderance of the analysis has been in respect of banking institutions, owing to their central role in the crisis and the ensuing systemic risk. The findings of this research are currently being implemented through a combination of voluntary and compulsory initiatives, whether via company law, listing requirements or prudential requirements, as the case may be. In seeking to implement the requirements drawn from this research, we similarly look to the Financial Regulator to consider the proportionate implementation of the requirements and to focus primarily on those elements that are matters of alignment with prudential regulation.
1.4	9	We welcome the distinction drawn in this paragraph between different institutions but it is not clear to us how it interacts with the minimum requirements suggested elsewhere. There could be considerable practical difficulty if regulatory approval is required for minor deviations from the proposed requirements.
1.5	10	The definition of major institution and the concept of proportionality and how it will apply are aspects of significant uncertainty in the requirements. This uncertainty should be addressed in the final version, seeking a mechanism to make compliance requirements a clearer matter for institutions.
3.0 General Requirements	13	
3.1	13	There appears to be a contradiction between this statement and the concept of proportionality in 1.4 and we would ask that the interaction between the two sections be clarified.
3.2	13	We support this assertion and see it as consistent with the systems of governance requirement embedded in developing legislation, such as the Solvency II initiative for insurance and reinsurance undertakings. Institutions should be required to have mechanisms that provide for the Board to monitor and appraise the management of the institution. Mechanisms are also required to enable issues to be escalated to, and properly considered by, the Board from layers of operation below senior management.
3.7	13	This requirement would not be appropriate without the Director seeking in the first instance to have any concerns addressed within the institution.
4.0 Composition of the Board	15	
4.1	15	There needs to be clarity over what the Board is expected to deliver prior to determining the composition. Thus, what is expected from the Board of a plc with widely held shareholdings and a large number of diverse directors and sub-committees will be wholly different to what is expected from the Board of an internal subsidiary.

		A requirement for independence in the case of an internal subsidiary may be less important than expertise and familiarity with the shareholder. Furthermore, the scope of an independent Chairman may in substance be limited in such circumstances and thus solely achieve the appearance of control. We believe that a key benefit of independent directors is their perspective and, in particular, they can pose a significant antidote to excessive “group think”. This added value will be of aid to management and to shareholders, as the case may require, but does not necessarily require that the independent voice is that of the Chairman. As a specific comment, we would note that the specific requirement suggests that each of the (potentially multiple) undertakings of an overseas-regulated entity would require an independent Chairman. In conjunction with the requirement of 5.10 that a Chairman may not hold the chairmanship of more than one institution at any one time, this requirement would create significant practical difficulties. This problem could be avoided by making 5.10 inapplicable to multiple subsidiaries in one regulated institution so that one independent director could chair a number of subsidiaries.
4.4	15	A director cannot be considered to be able to fulfill his role if he has a significant portfolio of conflicting requirements. The requirements of 4.4 outline the need for the Board to articulate the time commitment associated with a role. Boards should also be required to assess whether a potential director has sufficient time and to establish a contractual obligation, on the part of the director, to fulfill the time commitments.
4.5	16	The aims implicit in the limit are understood. However, in practice, the limit does not recognise the diversity of circumstances that can arise. Such a low limit will result in a greater spread of directors and could result in a lower level of expertise on Boards, in particular where individuals who demonstrably have the time available, and the skills set out in 7.4 to a high degree, would be prevented by this clause from taking on additional directorships. For “major institutions”, these limits are justifiable but, for other institutions, we feel that the Board should be required to consider and justify (1)the extent of time requirements, and (2) the complexity of the institution in question in the first instance rather than just checking a rule. For example, 3 could be too many for someone in full- time employment elsewhere whereas a full-time non-executive director could have much greater time availability. As an example of the potential consequences of such a rule, there is a risk that smaller institutions will not be able to attract the most qualified people with the most relevant experience as such individuals may not wish to restrict their ability to take roles with larger companies. This could result in a deterioration of governance for some institutions.
4.6	16	The same considerations apply as per section 4.5.
4.11	17	The Requirements need to be strengthened to address more comprehensively how directors and Boards should deal with conflicts of interest where the possibility or fact of the conflict emerges after the director is appointed. For example, a requirement could be included that director appointments should be reevaluated, with a view to assessing whether or not they should continue, if the potential for significant conflicts of interest arises after appointment.
5.0 Chairman	18	
5.6	18	This requirement could result in less effective governance for some of the many institutions that are subsidiaries of an international group. In many instances, the Chairman of the Board is an important link to the group and facilitates important two-way communication, as an executive within the group. However, this would no longer be possible to the same extent, if the Chairman must be independent. We consider that the independence requirement in this instance could produce less effective governance for some companies.

5.8	18	The obligations and requirements on the Chairman of a major institution are considerable and it is widely recognised that the role requires almost full-time attention and arguably leads to the role being an executive director role in substance if not in form. However, the application of the proposed requirement to smaller and/or less complex organisations is disproportionate for many of the reasons outlined elsewhere in this response. Such a requirement might make it difficult to attract people to the position of Chairman as they might be reluctant to commit and thereby limit their scope to take on other roles.
5.9	18	This is an appropriate requirement in the context of ensuring there is not unfettered power in the hands of any one person.
5.10	18	This should be reconsidered in the case of multiple subsidiaries of a regulated multinational, i.e. each of the subsidiaries should not count as a separate institution for this purpose.
6.0 Chief Executive Officer	19	
6.1	19	This role may be apparent in many major institutions. However, how should the CEO be identified in the matrix structures that are common in subsidiaries of many international groups? Thus, for example, where there are functional reporting lines into a group headquarters that do not necessarily pass through or solely pass through the local CEO, is the CEO still considered to be the apex of control and the driver of the Executive on behalf of the Board?
8.0 Role of the Board	21	
8.3	21	Notwithstanding the Board may not abrogate responsibility to sub-committees, the effect or de facto result of increased specialisation of the Board into discrete sub-committees may be to reduce the overall effectiveness of a Board as a cohesive unit and may inhibit universal engagement on key issues.
9.0 Appointments	22	
9.7	22	This requirement can be implemented only to the extent that there is an identified head of the various Control Functions, which is not currently the case for all undertakings covered by the proposed requirements.
11.0 Meetings	24	
11.1	24	Each Board should meet as often as is appropriate and its directors should assess whether or not they are satisfied with the frequency and content of their meetings, given the obligations that they are required to discharge. Specifying the default frequency for meetings will not necessarily enhance governance aims. Indeed, the dilution of a Board meeting to a regulatory requirement may diminish the standing of all Board meetings and the measure may therefore be counterproductive. A requirement that had regard to the matters to be addressed though the annual cycle of Board meetings would be more productive than one focused on frequency of meetings.
13.0 Consolidated Supervision	26	
13.1	26	The corollary of this is that the group oversight functions can have a material positive and supportive effect on the governance of subsidiaries, the impact of which can usefully be taken into account in demonstrating adequate corporate governance.

17.0 Audit Committee	30	
17.2	30	This requirement, taken in conjunction with the requirement in 17.4 that the Chairman of the Board shall not be a member of the Audit Committee, effectively imposes a requirement for at least 4 non-executive directors on the Board, of which 3 (including the Chairman) must be independent. This is inconsistent with (or augments) the requirements in 4.1.
18.0 Risk Committee	31	
18.1	31	There is a conflict between 14.1 which states that "The Board shall establish, at a minimum, both an Audit and a Risk Committee" and 18.1 which states "Smaller institutions … may propose to the Financial Regulator that the Board itself carry out the functions which would otherwise be delegated to a Risk Committee".
21.0 Compliance Statement	31	
21.1	34	The Compliance Statement should include an explanation of any instances of non-compliance.

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