Recent developments in the IAIS and OECD on Insurer Corporate Governance

Timothy Bishop
OECD
Gabe Shawn Varges
Swiss Financial Market Supervisory Authority; Member of the IAIS/OECD Governance Subcommittees

ASSAL/OECD/IAIS Conference Mexico
April 27 2009

1. Agenda

I. Introduction and Context (Gabe Shawn Varges)

II. Background on Joint IAIS/OECD Initiative (Timothy Bishop and Gabe Shawn Varges)

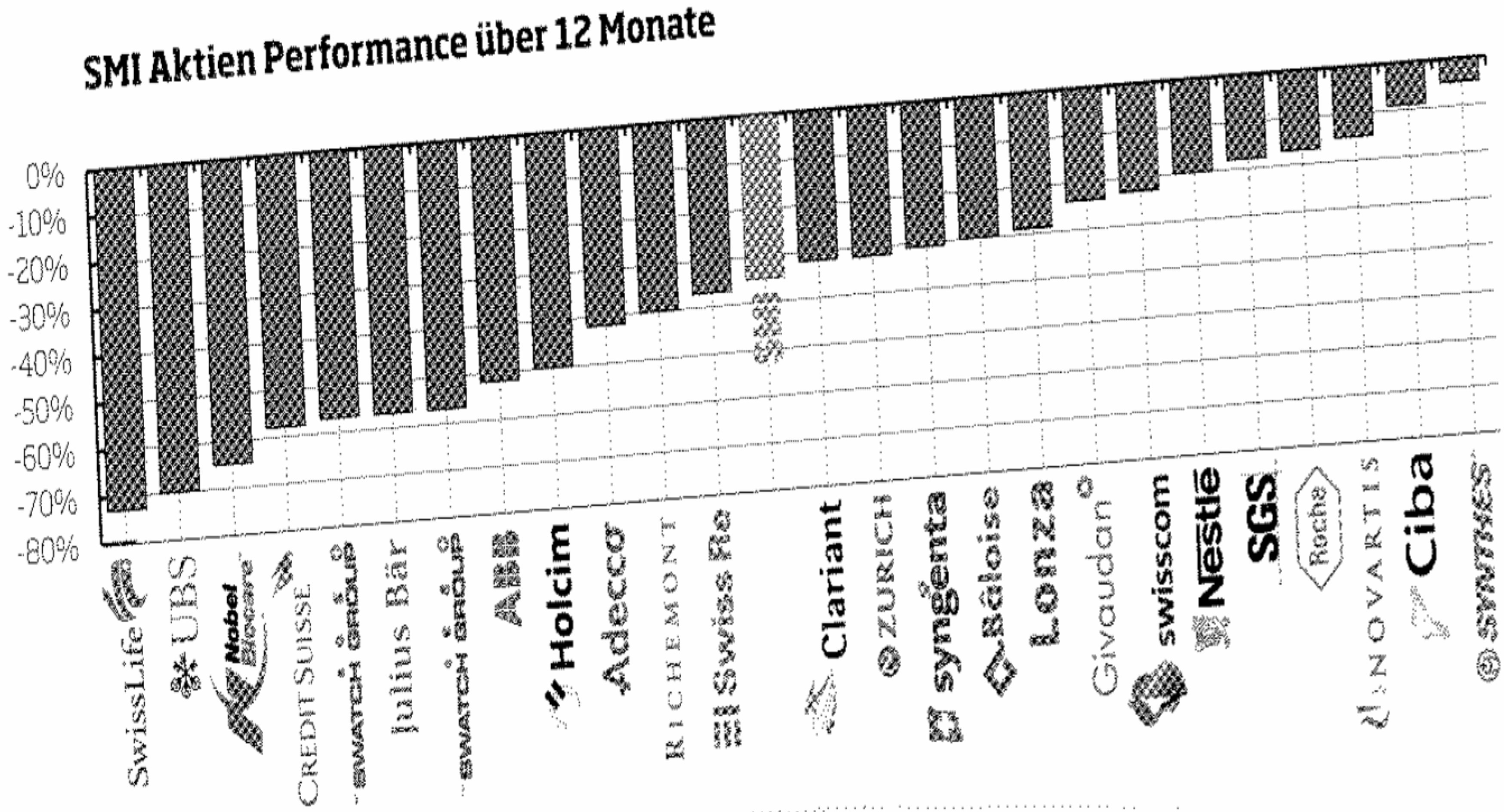
III. OECD / IAIS / WORLD BANK Survey Results (Timothy Bishop)

IV. Key Elements of the Draft Issues Paper and Implications for Supervisors (Gabe Shawn Varges)

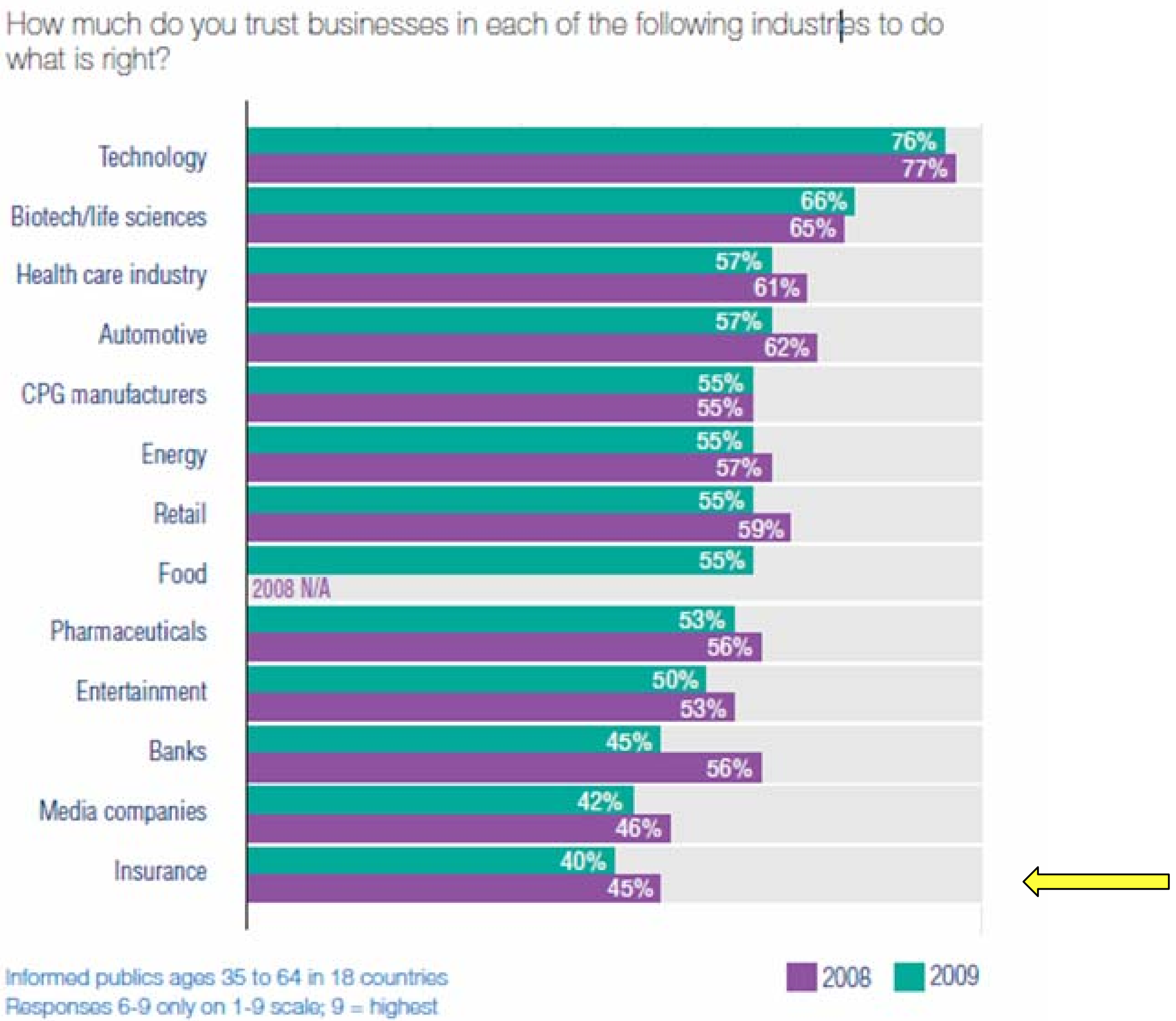
V. Next Steps and Q's & A's (Timothy Bishop and Gabe Shawn Varges)

I. Introduction and Context

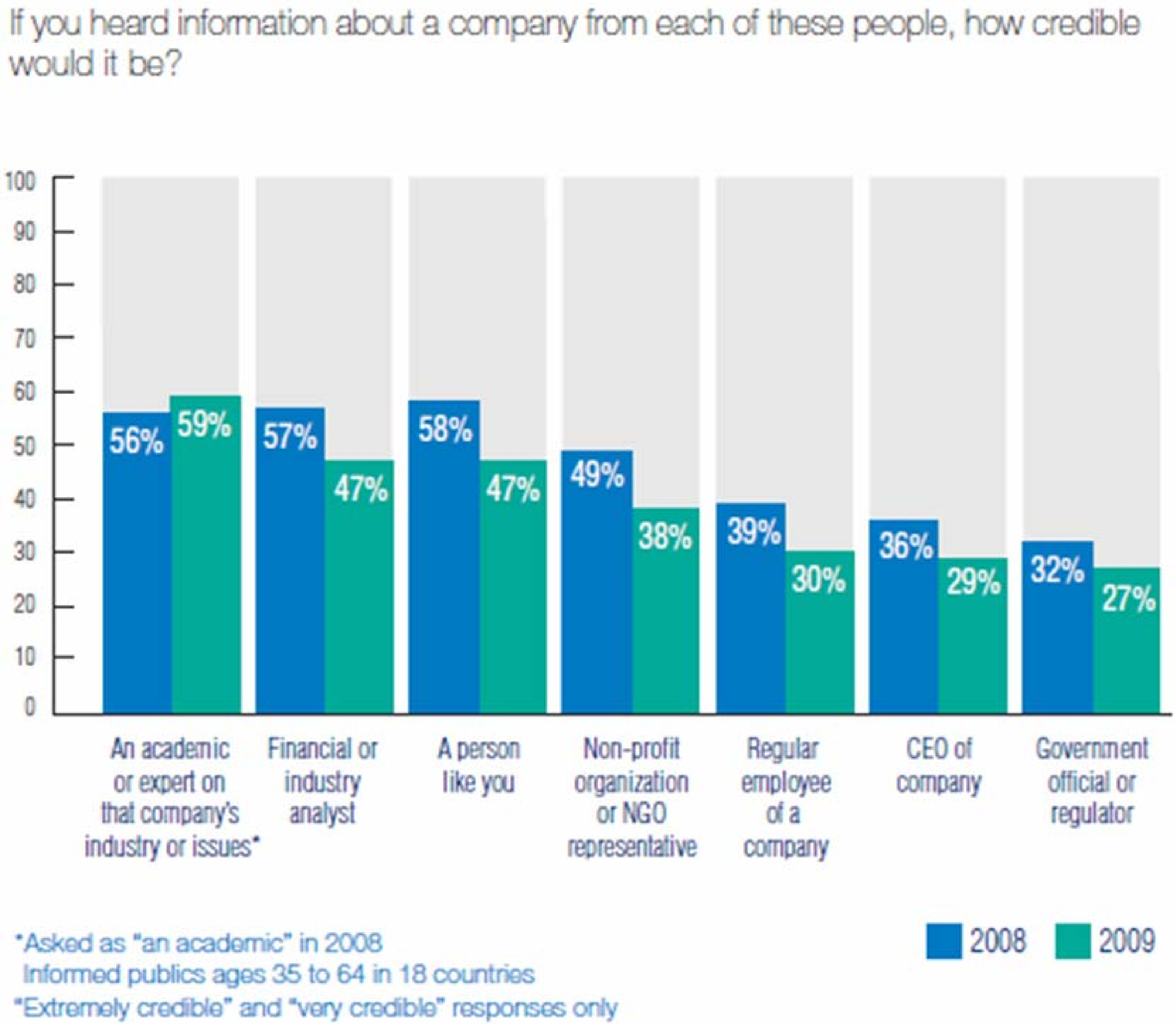
1. **Reach and impact of the current global financial crisis**
   - Cross-border and cross-industry contagion effect
   - Contagion even within company groups
   - Not just a financial services crisis
     - But important to recall difference as between banks and insurers
2. **Impact on public confidence and trust**
   - Not just spending confidence
   - Various surveys suggest a decline in public trust in companies, including insurers
   - And also a decline in trust in regulators


SMI Aktien Performance über 12 Monate
0%
-10%
-20%
-30%
-40%
-50%
-60%
-70%
-80%
SwissLife
UBS
Nobel Biocare
Credit Suisse
Swatch Group
Julius Bär
Swatch Group
ABB
Holcim
Adecco
Richemont
Swiss Re
SMI
Clariant
Zurich
syngenta
Bâloise
Lonza
Givaudan
swisscom
Nestlé
SGS
Roche
Novartis
Ciba
Synthes

Impact on Public Trust in Insurers



Source: Edelman TrustBarometer Feb. 2009

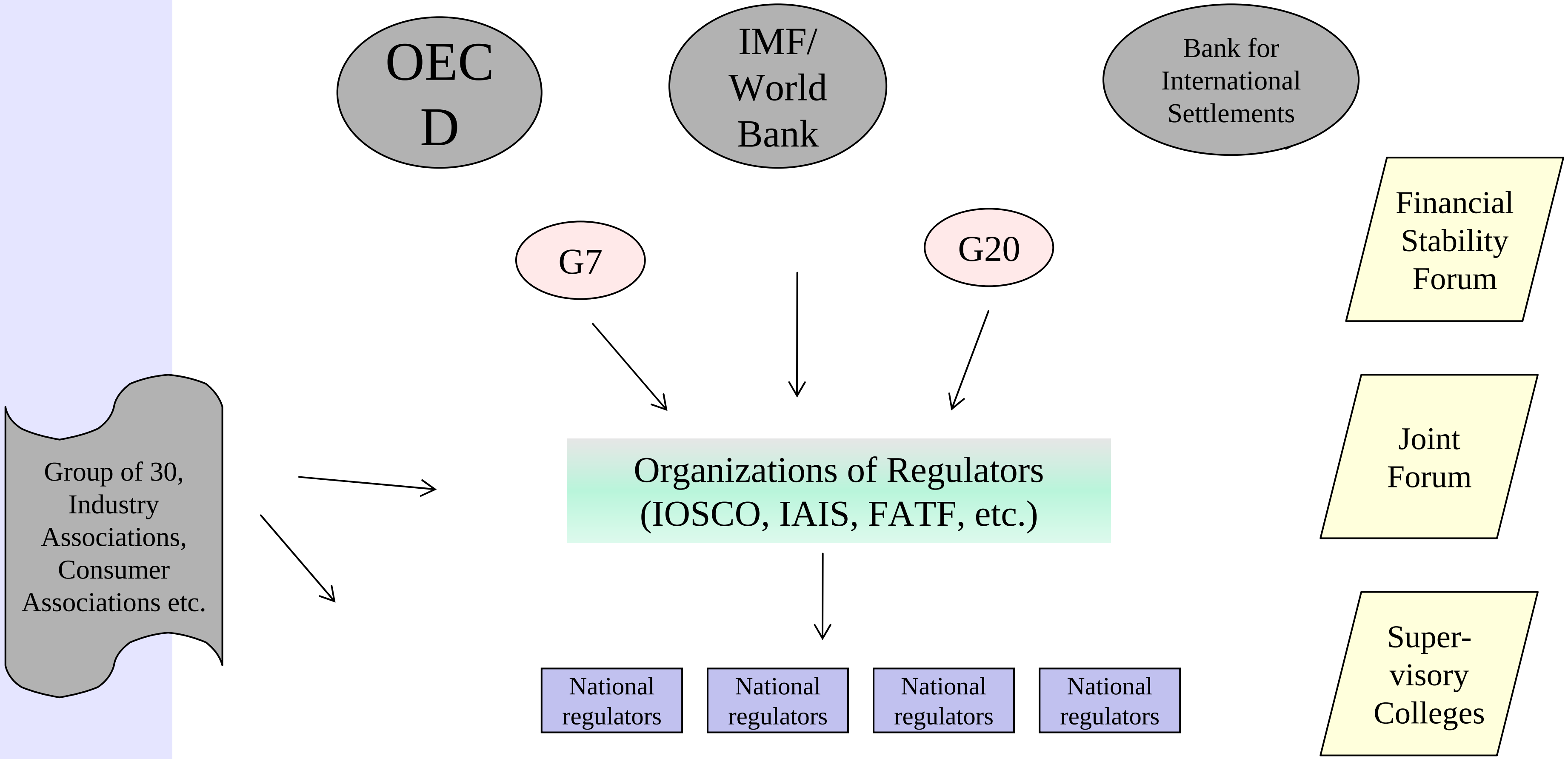


Source: Edelman TrustBarometer Feb. 2009

3. Governmental responses

- Wide effort to seek to understand the “pressure points” and source of the crisis
- A consensus building on need to rethink and reform regulation and supervision under public pressure to do “more”, including in respect of “systemic” relevant companies and potential “regulatory gaps”
  - High interest in internationally active companies and conglomerates and cross-sectoral issues
  - High interest in supervision from a more macro perspective
- G7/G20, IMF, OECD, Financial Stability Forum and others
- Also positive role of standard setting bodies, like IAIS
- National and regional responses
  - Example UK: Turner Report
  - Example EU: de la Rosière Report
    - EU Systemic Risk Council (macro)
    - 3 EU Banking, Securities, Insurance authorities (micro)

Pressure on national regulators from different sources



4. Industry and private sector responses

- Industry and private sector also active, fearing perhaps in part a disproportionate response from regulators
  - Example: Group of 30’s “Financial Reform a Framework for Financial Stability”
  - Example: International Federation of Accountants 2/09 Report on Evaluating and Improving Governance in companies
  - Example: Wall Street Goldman Sachs CEO coming out publicly on April 8 in favor of compensation reform
    - Compensation as a case-in-point of potentially
      - » insufficient anchoring in governance
      - » insufficient independent decision making by boards of directors
      - » Insufficient involvement by control functions

Goldman CEO supports new guidelines on pay

BY SARAH N. LYNCH

WASHINGTON—The chief executive of Goldman Sachs Group Inc. called for industry reforms on how executives are paid at financial institutions, saying compensation should discourage excessive risk-taking that may put the company and the markets at risk.

"We should apply basic standards to how we compensate people in our industry," Lloyd C. Blankfein told an audience Tuesday in prepared remarks at the Council of Institutional Investors' annual conference.

"Compensation should reflect an individual's ability to identify and create value, including his or her contribution to the client franchise, enhancing the firm's reputation and contributing to the better functioning and efficiency of markets. Equally important, compensation should take into account strict adherence to a firm's management and controls, especially with respect to a person's judgment and exercising that judgment in terms of risk in all of its forms."

Compensation practices at financial institutions have stirred public outcry, particularly in the U.S., where trillions of dollars have been spent to bail out companies such as Goldman Sachs and American International Group Inc.

The backlash prompted Congress to impose limits on executive compensation at firms that received bailout funds in February with the passage of the economic rescue bill. Last week, the U.S. House passed an even tougher measure that would allow compensation packages to be curtailed before the stimulus was enacted. The bill now must go before the U.S. Senate for consideration.

On Tuesday, Mr. Blankfein's remarks were interrupted by protesters who walked up to the podium and unveiled a sign, which read: "We want our $$$$ back."

"We'll address that at the end," Mr. Blankfein told them, as some in

Please turn to next page

5. Corporate governance and the current financial crisis

- Consensus building that the current crisis is not only a market risk phenomenon
- OECD 11.2.09 Report concluded that the financial crisis

  "can be to an important extent attributed to failures and weaknesses in corporate governance...which did not serve their purpose to safeguard against excessive risk taking".
- IAIS has reacted to support also the G-20 and FSF recommendations in respect of various areas, including better risk management
  - Relation to debate on "governance" focus versus "risk management" focus
- IAIS Insurance Core Principle 9 (see next page) carries even more weight in today's environment

IAIS Existing ICP on Governance Contains Various Essential Elements

ICP 9	**Corporate governance**
	The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.

"Insurers must be managed prudently"

"transparency, independence, fairness.."

"the manner in which boards of directors and senior management oversee the insurer's business…and are held accountable "

"responsibility"

"timely and accurate disclosure on all material matters…including financial situation, performance…governance arrangements"

"compliance with legal and regulatory requirements"

"the supervisory authority requires and verifies that the insurer complies with applicable corporate governance principles"

6. **But in light of the current crisis and in general, where does corporate governance need change or strengthening?**
   - At the company level?
   - At the regulatory or supervisory level?
   - In which areas?
   - Not to be looked at in isolation:
     - Relationship also to other key regulatory and supervisory concerns including in terms of solvency, risk taking and risk management, governance of groups/conglomerates and internationally active insurers, regulatory and supervisory gaps etc.
     - Relationship also to complementary role of self-regulation
   - Important also to look at best practices that have been emerging over a longer period of time, not just during the crisis

II. Background of the Joint OECD/IAIS Initiative on Corporate Governance

- **The IAIS Governance and Compliance Subcommittee established in 2008**

- **The mandate of the Subcommittee**
  - Develop high level corporate governance papers, using the material and findings of the Corporate Governance Task Force
  - Carry out a survey into industry practice with the assistance of the World Bank and the OECD

- **OECD Insurance and Private Pensions Committee (IPPC)**
  - Established OECD *Guidelines on Insurers' Governance* in 2005
    - Provide a roadmap for sound insurer governance
    - A legal instrument of the OECD
    - Complement to OECD *Principles of Corporate Governance*
  - Council-mandated review to ensure continued relevance and application
  - Establishment of an informal Task Force on the Governance of Insurers to facilitate the review
  - Decision to cooperate closely with IAIS

III. OECD / IAIS / World Bank Survey Results

- **Survey initiated in July 2008**
- **Survey covered a wide range of governance issues for insurers**
- **Insurers, insurer trade associations, supervisors and others responded**
- **High-level summary survey report**
  - Prepared by the World Bank
  - Published as part of consultations on draft Issues Paper

Survey key findings

- **Confirmed importance of fit and proper board members and senior management and board independence for sound governance**

- **Recent and anticipated changes in governance driven by**
  - Regulatory influences, including response to corporate scandals and upcoming Solvency II
  - Evolution of insurer and industry best practices
  - Adoption of group-wide practices
  - Adoption of best practices driven by disclosure and market expectations

Governance structure: drivers

- **Supervisors**
  - Prudential rules
  - Controlling intra-group transactions and shareholder risks

- **Industry**
  - Policyholder rights and interests
  - Prudential rules
  - Nature of insurance contracts and activities
  - Expectations of CSR

1. Committees

- **Audit and risk management committees most important**
  - Common view of supervisors and industry
  - Audit committee the most commonly established

- **Remuneration and nominations important**
  - Current discourse on remuneration is relevant
  - Nominations play a key role in fitness and propriety

- **Practice well ahead of mandatory requirements, driven by**
  - Business needs
  - Cross-border ownership by international firms
  - Market best practices and expectations

- **In many jurisdictions, no minimum requirements**

2. Risk management

- **Function generally centralised but varying practice**
  - Centralisation means different things to different respondents
    - Centralised globally versus centralised within a regional or local operation
  - Cost, independence, and limited expertise drive centralisation
  - Extent of independence varies
    - From part of internal audit
    - To full separation with CRO
  - Relevance and impact of group practices
  - Regulation and market forces as key drivers

- **Impediments to effective risk management**
  - Inadequate data & technology, cultural issues, staff training, and other

3. Management of conflicts of interest

- **Importance of**
  - Disclosure / transparency
  - Board or board committee review of individual transactions
  - Reliance on adequate policies and procedures

- **Supervisors noted supervisory control whereas industry rated this lower than in other areas.**
  - Particular difference of view on participating policyholder issues where
    - Insurers emphasised role of general assembly, disclosure, and the actuary
    - Supervisors emphasised regulatory requirements and solvency rules ahead of board functions and other governance oversight

4. Independence of control functions

- **Key functions that should be independent, in the view of supervisors**
  - Actuary (67%)
  - Internal audit (64%)
  - Risk management, compliance (39%)

- **But less clear on how this should be achieved**
  - Support highest for mechanisms to promote an independent internal audit function, above those for actuarial function
    - E.g., independent personnel and performance evaluation, board access, access to external auditor, board or supervisory oversight)
  - Supervisors identified direct reporting lines, board meeting participation, access to external audit, and board/supervisory oversight as the most effective mechanisms for independence
  - Industry shared similar view, but less priority given to participation in board meetings

5. Groups and conglomerates

- **Authority exists in many jurisdiction to review governance within the head of a group**
  - Powers may be more limited if head is unregulated

- **Many challenges, including**
  - True independence of board of insurers within group
  - Assessing group-wide risk management
  - Complexity and related party challenges
  - Exposure to non-insurance (and less understood) business
  - Closely held insurers
  - Cross-border supervisory cooperation

- **Many insurers have adopted group-wide practices, but recognise local obligations**
  - In some cases, no general global practices

Board functions

- **Common written policies include risk management investment strategy, and reinsurance**

- **Importance of clear criteria and minimum number of independent directors in promoting independence, but many other mechanisms**
  - Some jurisdictions have no independence requirements; many do not require board majority
  - Ethical standards and CSR have an impact
  - Expected reporting of management, committees, actuaries, and internal & external auditors to the board

Board fitness and accountability

- **Board fitness**
  - Fit and proper requirements
  - Orientation and ongoing training
  - Periodic assessments of directors
  - Role of nomination committee
  - Other factors and requirements, e.g., limits to board size, maximum number of directorships, maximum tenure
- **Accountability mechanisms include**
  - Annual general meeting
  - Board election
  - Self-assessments (group and individual)
  - Reporting to supervisor / supervisory oversight
  - Disclosure of governance and management practices

Remuneration

- **Importance of**
  - Linkage to long-term performance
  - Clearly defined criteria and measurability
  - In some cases, role of remuneration committee

- **Short-term performance still relevant – mixture**

- **Disclosure of remuneration policies supported by both supervisors and insurers (principally via annual report)**

- **Overall, work in progress in many insurers**

Actuary

- **Function required in many jurisdictions for all insurers**
- **Some jurisdictions – life insurers only**
- **Key duties**
  - Product development / pricing
  - Advice on technical provisions
- **Qualification requirements often exist but not necessarily transparent / fair criteria or process**
- **Requirement / expectation to play a supervisory role**

External auditor

- **Different methods of appointment**
  - Insurer’s management
  - General assembly / meeting
  - Audit committee / board

- **Qualification requirements and controls for independence, but not necessarily disclosure of selection criteria or process**
  - Many insurers look to professional standards and major firms as selection criteria for quality

- **Obligation to report irregularities to supervisors – a requirement shared with actuaries**
  - But requirement more common for external auditors

Identified lessons from the crisis

- **Investment strategies and risk appetite**
- **Complex products and lack of corporate oversight**
- **Lack of early and adequate communication flows**
- **Need for tight internal controls and risk management**

Survey overall

- **Input is useful for future work**
- **Practices vary widely**
  - Some for good reason
  - Some due to developmental status of processes
- **Regulation matters**
- **International insurers have a positive effect**
  - But local requirements present challenges
- **Disclosure and market expectations matter**
- **Consistency with discussions at the special IAIS-OECD roundtable in December 2008**

IV. Key Elements of the Draft Issues Paper and Implications for Supervisors

- **Focus is on the corporate governance of *insurers***
  - Recognition of different types of insurers

- **Topics are addressed in a manner which is consistent with existing IAIS and OECD work**
  - Recognition of jurisdictional differences
  - Aim to find areas of commonality
  - Principle of proportionality to take into account different size insurers and different risk profiles

- **Provides a basis for further work by the IAIS and OECD**

Draft issues paper on corporate governance

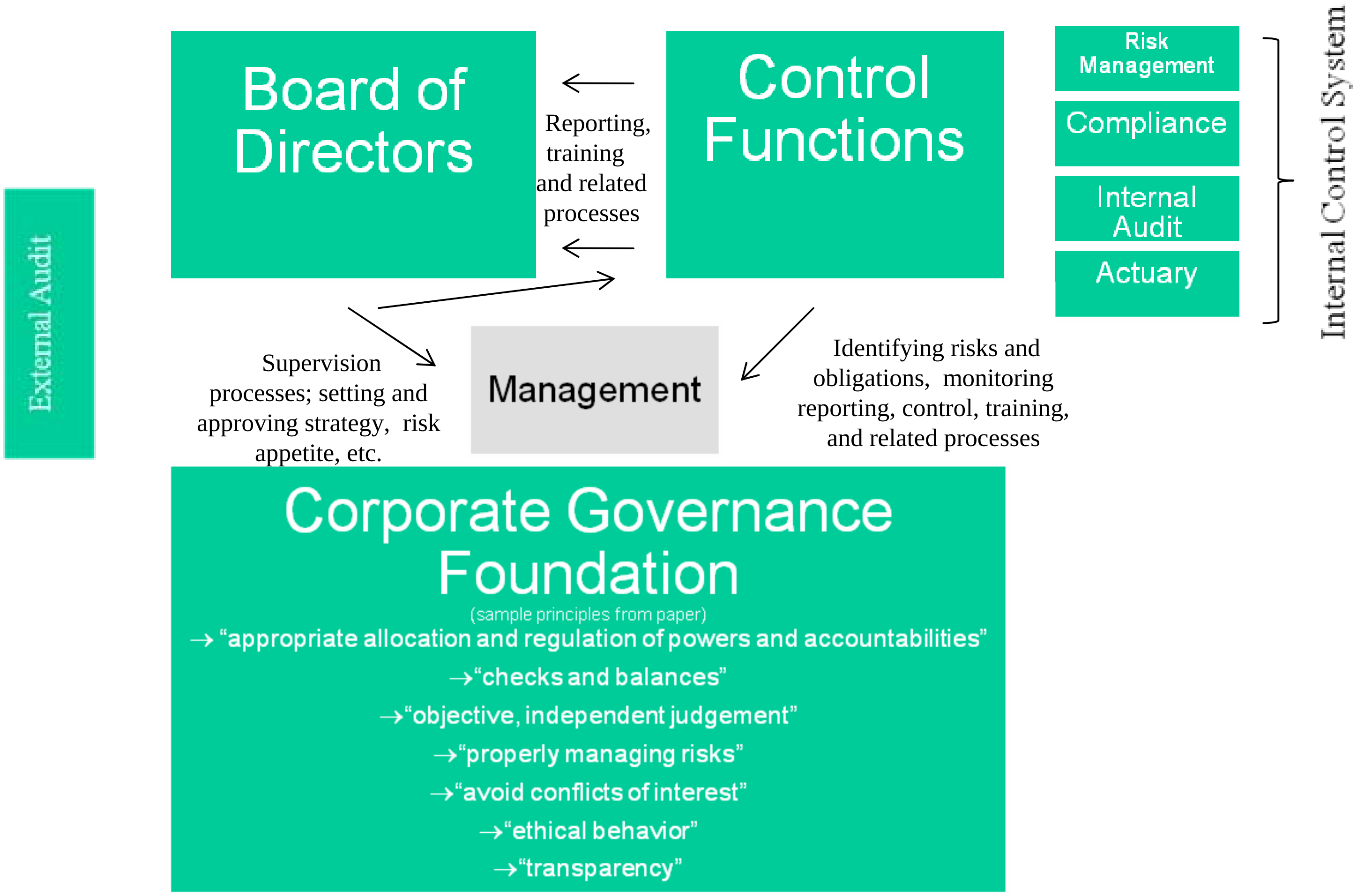
- **Recognizes that the way an insurer governs itself can affect its decisions, practices and risk profile**

- **The paper identifies issues relevant**
  - To determining if an insurer's governance is sound and appropriate for the nature, scale and complexity of the business and its overall risk profile and
  - To assessing if it is being adequately implemented
  - To addressing lessons learned from the recent crisis
    - Example: Ensuring robust processes for making investment or other risk decisions and ensuring these not based solely on credit rating agencies or other such parties
    - Example: potential risks of wrong incentives through bonus and other compensation structures

Draft issues paper on corporate governance

- **The paper touches on:**
  - Foundations of corporate governance
  - Governance structures
    - The functions and committees of the board
  - Control functions
    - Risk Management
    - Compliance
    - Actuary
    - Internal and external auditor
  - Reporting to the Board of Directors and Mechanisms for employee reporting of potential breaches
  - Disclosure and transparency
  - Relationship with stakeholders
  - Interaction with the supervisor

Another Way to View the Key Areas of Focus of the Issues Paper (those in green)



Important: this is a simplified depiction; not complete; please refer to entire issues paper

Implications for Supervisors

- **The OECD/IAIS paper is only an “issues paper”**

- **But it is an important signal that governance and all its components are**
  - Also part of the lessons learned from the current crisis
  - (perhaps more importantly) an essential element *at all times* of
    - Sound management by companies of their business
    - Sound supervision by the regulator

Why does corporate governance matter to the Supervisor?

- The Supervisor cannot see or stay on top of all risks a company faces on daily basis or how well the company understands and complies with all its obligations
- The Supervisor has limited resources
- The Supervisor has to have some reliance on the Board of Directors and the control functions of a company

- The task for the Supervisor thus is not just to know the risks of a company
- But also to know how well the company is positioned and resourced to deal with these risks and to meet its obligations

- **Hence a key challenge for the Supervisor is increasing its own ability to assess the readiness, the capabilities, and the performance of the Board and the control functions**
- Another challenge is how to appropriately support their role in the governance system of a company.
- Importance of training

V. Next Steps and Q's & A's

- **Consultation period of IAIS Members and Observers and members of the OECD IPPC is currently running**
  - Available on IAIS and OECD websites together with the survey report
  - There is still time for input: the deadline for comments 30 April 2009

Draft issues paper on corporate governance

- **If submitting comments you may wish to consider the following issues:**
  - Whether the corporate governance issues discussed in the issues paper are the relevant ones in relation to the governance of insurers.
  - Whether there are other aspects of insurer governance that should be addressed specifically in future IAIS and/or OECD papers.
  - Whether the lessons learned from the financial crisis have been sufficiently covered.

Future work of the IAIS Governance and Compliance Subcommittee and OECD IPPC

- OECD to review 2005 *Guidelines on Insurers' Governance* for possible updating and revision
- IAIS to update the Insurance Core Principles and draft a Standards and Guidance Papers
- Scope of future cooperation between OECD and IAIS to be determined
- Before advancing this work due regard will be given to other work underway in the two organisations
- Efforts will be made to minimise any unnecessary duplication and overlap