CORPORATE GOVERNANCE

RESPONSE TO CP41

Respondent: Dermot Gorman FCII Chartered Insurer

Contact details: email: Dermot.gorman5@upcmail.ie; mobile: 086 3844097

Respondent Background: I am active as a non executive director in the insurance sector, with 30 years prior industry experience split between domestic and IFSC insurance undertakings, including 10 years at executive director level.

Scope of Response: My response is written from the perspective of an insurance practitioner principally concerned with the international (IFSC) sector; it focuses on the impact to that sector of the proposed changes, with particular emphasis on the role of the non executive director.

Structure of Response: This paper sets out a brief series of general observations and then comments as appropriate on the detailed proposals in the sequence that they appear in CP41. The recommendations made are then summarised at the end of the paper.

A. GENERAL

The consultation paper is a welcome step in increasing attention to corporate governance in financial institutions and in putting forward specific proposals to enhance the relevant processes. However many of the detailed proposals in their current form raise practical issues which suggest a need for considerable refinement before final guidance is issued; the detailed proposals are dealt with later in this paper. In general I have the following general observations:

- I would question whether it is appropriate to introduce specific quantitative or prescriptive guidance in so many areas in the absence of specific evidence that these items have contributed decisively to the failures of the recent past. If, as suggested at para 1.1 of the preamble to CP41, those failures have largely been ones of understanding, analysis, and behaviour, a greater emphasis on the content and quality of governance rather than it's form(s) would in my view be appropriate. The fact that many of the larger domestic institutions which have featured prominently in the events of the past two years were already subject via their adoption of the Combined Code to many of the measures prescribed in CP41, reinforces in my view the need to consider more deeply the qualitative changes needed.
- A single standard that will apply equally to banks and insurers is in my view problematic given the divergence of experience between the two sectors throughout the recent crisis, the relative lack of systemic risk in insurance undertakings, and the differences in industry structure in Ireland. It should be considered that there is a much larger number of insurance undertakings based in Ireland than credit institutions, and within this a greater spread and diversity of firms (while the definition of "institution" in CP41 suggests otherwise, I understand that the proposals were intended to also apply to reinsurance undertakings). Consideration should therefore be given to issuing separate guidelines for the (re)insurance industry.
- While CP41 acknowledges the need for proportionality in distinguishing between firms of varying nature, scale and complexity, this is not sufficiently reflected in the detailed proposals many of which allow very little scope for variation in response to these factors. This point arises in so many areas that a more developed framework is clearly called for. There is a particular issue in the application of the proposals to IFSC companies that are part of larger financial groups. An expanded framework could take a number of forms, such as distinguishing between the risk/impact profile of varying institutions, retail and wholesale institutions, domestically-headquartered financial groups compared to subsidiaries of international groups, or measures of financial scale and complexity, or combinations of these factors. A framework that categorises firms into perhaps three tiers would seem appropriate for the insurance industry. To be clear, the argument is not for large sections of the industry to be exempt from the proposed measures but rather for a framework that would allow for a proportionate application of the measures to all relevant firms. There are however some sectors, notably captive insurers, where there is a strong case for disapplying most of the measures and the paper indicates that this is accepted as a broad principle. I believe the relevant industry representatives will be making detailed submissions as to how this might be achieved; for this reason I have not directly referred to the position of captives in the comments which follow.

B. DETAILED PROPOSALS

The points made below are in response only to those specific items where some form of modification is suggested; approval or neutrality can be assumed in all other cases.

1.3 It is perhaps surprising that the Walker Review, the UK Treasury-commissioned post-crisis review of financial institutions governance and as such the only in-depth study of the issues in a neighbouring jurisdiction is omitted from the list of sources. While there a number of areas where the CP41 proposals coincide broadly with the recommendations of the Walker Review, there is no direct evidence of its findings having been studied.

1.4 This indicates that the full requirements will to major institutions, but that implementation for other firms may be varied for reasons of proportionality. While the assertion of intent is welcome, there is very little evidence elsewhere in the paper of attempts to follow through on this at a detailed level. As indicated earlier, a framework is needed which would distinguish between firms of differing scale, economic significance and ownership, beyond the partial exemption for captives referred to at para. 6.3 of the preamble.

2.0 The legal framework invoked is confined to existing legislation. In the case of the insurance industry, I suggest that regard should be had to the provisions Solvency II Directive and the likely shape of implementing measures, about which there is now reasonable clarity in many areas. Given that the implementing measures are intended to apply directly in each member state with a high degree of harmonisation, I would question whether the more prescriptive CP41 proposals are consistent with the Solvency II framework, and in particular whether the principle of proportionality has been adequately recognised within the proposals.

3.1 Again the reference to the CP41 proposals as being the minimum requirements that an institution shall meet is difficult to reconcile with 1.4 or with the other references to proportionality throughout the paper. In a number of areas the proposals exceed current and proposed future standards applying to major publicly-quoted financial institutions in other jurisdictions.

4.1 In general I would question whether a simple majority of non executive directors will effect any significant change in all but the most extreme cases, especially when major transactions of the firm are separately subject to regulatory clearance. There is a danger that this provision will effectively limit the number of executive directors available to inform the deliberations of the board, and that the need for an appropriate balance and spread of directors with relevant knowledge will be ignored. It is noteworthy that while the UK Corporate Governance Code (successor to the Combined Code) continues to suggest that half of directors excluding the chairman be independent for quoted companies, the Walker Review suggests that financial institutions may have to consider departing from this standard because financial experience may be more important than independence in the effective governance of such companies. While the possible use of non independent directors may assist in recognising this, the practical ability of large international groups to draw on suitable candidates resident in other countries is limited in practice by tax considerations. It is unclear whether senior employees that may have indirect functional responsibility for the firm as part of their wider group accountabilities would be considered non-executive for these purposes and this should be clarified. Furthermore, 4.1a implies a possible choice for these firms

between a majority of independent directors vs. an independent chairman; however 5.6 later indicates the chairman must be independent in all cases. In my view a less prescriptive standard should be developed, calling for an appropriate balance of executive and non-executive directors with a spread of skills appropriate to the firm subject to a minimum of perhaps two independent directors.

4.2 The requirement for a voting majority of non executive directors at all board meetings would extend the involvement of non executives to a range of routine transactions which are usually carried out by executive directors with prior notice to the full board and optional attendance by non executives. This may not be an appropriate use of non executive time and resource in all cases.

4.4 The proposal to make director's expected time commitments explicit on appointment is welcome in terms of transparency and fit with the directors other time commitments. To make this meaningful and ensure a degree of consistency across firms, it would be desirable to also specify a range of other matters covered in CP 41, including frequency of board meetings and participation in sub committees. For reference, the Walker review concluded that for NEDs with significant subcommittee involvements on FTSE 100-listed major banks a minimum time of 3 days a month was appropriate. I would suggest that very few Irish-domiciled financial institutions fall into this category and that for most supervised firms a materially lower time commitment would apply in normal circumstances.

4.5 No specific rationale is put forward for the form or calibration of this proposal, other than the general reference in para 1.5 of the earlier preamble ("to ensure [NEDs] can comply with the expected demands of Board membership of an institution"). In the absence of any additional commentary one assumes this refers to time demands and is related to 4.4. While measures to ensure that non executive directors can devote sufficient time to their duties are clearly reasonable, the proposal in its current form raises a number of concerns:

- A simple numerical limit on financial directorships takes no account of the differing time requirements across firms of varying scale and risk profile. These can vary significantly depending on the nature of their business, whether a subsidiary in a large financial group, their subcommittee structure and composition etc. Moreover, a limit of the type proposed risk creating a situation where candidates with the most relevant experience and skills will gravitate exclusively to the larger firms leaving smaller firms to be served by candidates with less specialised backgrounds thus reducing the scope for NEDs to act as conduits of best practice from e.g. large international companies to smaller firms by serving on boards of varying size and complexity.
- See the comments above on 4.4 regarding the Walker Review recommendations: if 3 days a month is a realistic best estimate for directorships with sub-committee work for the very largest listed banks, it is very difficult to see how a greater number of financial appointments than three could not be supported once the directors overall time capacity is not unduly limited by other commitments. Conversely, there may be extreme cases where a large systemically important firm requires intensive attention for a prolonged period and it would be inappropriate for its directors to have any other significant commitments elsewhere.
- Allowing scope for up to an additional five non-financial directorships may have the effect of encouraging candidates with specialised financial services backgrounds to spread their activities to other sectors and conversely encourage candidates with other backgrounds to take on financial directorships. It is not clear that this is the desired outcome in terms of boards' skill profiles and appears inconsistent with the provisions of 7.6. Moreover purely from a time commitment perspective it is not clear why for example

an individual with three financial, and three other directorships should be regarded as acceptable, but a person with four financial directorships and no other commitments should not be.

- Other than the general provisions of 4.7, no attempt is made to deal with non-directorship activities (consultancy, full or part time employment) which may significantly affect the time available to individual INEDs to serve financial firms, nor to distinguish between those working as so-called career non-executives and those with extensive other interests and time commitments.

It is doubtful whether any simple formula can adequately address these issues. It is interesting to note the FSA paper (CP 10/3) published in January 2010 in response to the detailed Walker review, which proposes simply that "It will be for the firm and individual, as part of the application for approval, to demonstrate they have given due consideration to the amount of time required for the role, and that the individual has the capacity to deliver it." My view is that a similar approach requiring firms and candidates to specify and explain should be adopted. If any explicit limit is to be introduced it should either be based on aggregate time commitment (days per month) to take account of these factors and to ensure a spread of suitably qualified candidates to all firms, or should distinguish between directorships by categorising firms into tiers for the purpose of the guidelines.

5.6 The requirement for an independent chairman appears excessive where the firm is a subsidiary of a large financial group. The rationale for an independent chairman in general is to ensure that a potentially large and diffuse group of shareholders is represented in critical votes. Where there is a single institutional shareholder it is arguably more appropriate that the chairman represents the shareholder/parent and is in a position to exercise influence with the shareholder in the event of contention. I would therefore suggest that this provision not be applied to subsidiaries of financial groups, whether the group is supervised in Ireland or elsewhere.

5.7 I would question whether annual re-election of the chairman strikes an appropriate balance between the need for some continuity and the possibility of change, particularly if the suggestion above regarding 5.6 is adopted. In cases where an independent chairman is required the combination of a short time limit and the restrictions proposed at 5.8 will potentially limit the availability of suitable candidates. The proposal for annual re-election may also encourage an inappropriate focus on short-term business results. For most firms, a time limit of three years appears more appropriate.

5.8 The requirement that all other appointments of a non executive chairman of all firms be subject to prior approval may restrict the number of independent candidates willing to perform such roles. Again, for benchmarking the Walker Review concludes that a time commitment of 3 days per week may be required for chairmanship of a large FTSE 100 bank and in practice many firms supervised in Ireland will require substantially lower input. As elsewhere, some gradation in requirements to take account of smaller firms and subsidiaries of international groups is indicated.

7.4 The requirements for relevant skill, experience and knowledge represent a raising of standards compared to traditional practice and e.g. the guidance on NED experience in the earlier corporate governance guidance for reinsurers. While this may well be appropriate, it is difficult to reconcile with the restrictions proposed elsewhere in CP41.

7.6 The imperative to maximise both expertise and independence when selecting INEDs is not necessarily well supported by the provisions of 4.5; see my comments above.

11.1 The suggested default standard of twelve board meetings per year is significantly in excess of current normal board meeting frequency for all but the largest firms or those at the apex of a publicly quoted company. For smaller firms or more narrowly focused subsidiaries of large groups a frequency of four per year is likely to be more appropriate bearing in mind the need in many cases for attendance by overseas directors. The suggested "default and derogate" approach raises a more general issue: if the intention throughout the paper is to set standards at a level appropriate to the largest firms and deal with other firms by exception, a significant investment in resources will be needed to ensure that derogations can be processed in a timely manner. More generally this approach risks introducing uncertainty and subjectivity, which could be avoided by proposing more graded or principle-based guidelines.

17.1 For subsidiaries of financial groups, consideration should be given to the audit committee requirements being met by equivalent group or regional forums, subject to satisfactory evidence regarding the functioning and composition of such bodies and in particular that the local firm's affairs are actively and effectively overseen by the forum, as distinct from simply being within its scope.

17.2 The requirement that the audit committee be composed exclusively of NEDs appears excessive: to function effectively the committee will require at least three members and there does not appear to be any reason why one of these should not be an executive as long as they are not involved in the work and outputs the Audit Committee reviews. In its current form the proposal risks skewing the selection process for NEDs generally towards candidates with a background particularly suited to audit committee work. I would suggest that the requirement be relaxed to being a majority of NEDs.

18.1 Same point as 17.1 above, but relating to risk committees.

C. SUMMARY OF RECOMMENDATIONS

General

- Give greater emphasis to qualitative issues and behaviour issues in the guidelines
- Consider introducing separate guidelines for the insurance sector
- Introduce a framework to distinguish between firms of varying nature, scale and complexity

Detailed Proposals

1.3 Consider the outputs of the Walker Review before finalising guidelines

4.1 Replace the requirement for a majority of non executive directors with a standard of an appropriate balance of executives and non executives and a spread of skills relevant to the individual firm, subject to a minimum of two independent directors

4.2 Relax the requirement for a majority of non executives to attend all meetings regardless of subject matter.

4.4 Expand the matters covered in appointment letters to include board meeting frequency and sub- committee membership

4.5 In line with the proposed FSA approach, replace a quantitative limit on directorships with an obligation on firms and candidates to demonstrate that the candidates can commit the necessary time. Alternatively introduce a control based on amount of expected time commitments.

5.6 Vary the requirement for an independent chairman in the case of subsidiaries of financial groups.

5.7 Consider extending the re-election cycle applicable for chairmanship of most companies to three years

5.8 Relax the requirements for prior approval of all a chairman's external activities

11.1 Introduce a graded approach to the frequency of board meetings proportionate to the nature scale and complexity of the firm

17.1 Consider permitting subsidiaries of financial groups to meet the Audit Committee requirements through equivalent regional or group forums

17.2 Vary the requirement for Audit Committees to be made up exclusively of non executive directors

18.1 Consider permitting subsidiaries of financial groups to meet the Risk Committee requirements through equivalent regional or group forums