DILLON EUSTACE

SUBMISSION

Response to Consultation Paper CP41 Corporate Governance Requirements for Credit Institutions and Insurance Undertakings

In this submission in response to CP41, our focus is primarily on the impact that CP41's proposals would have on the Irish based subsidiaries of large European financial services groups, particularly insurers whose Irish based head office subsidiaries predominantly transact business cross border into other EU members states rather than having any significant domestic Irish business.

Proposal : General Comments

Our general comments (i.e. those which would apply across the board to all regulated entities the subject of CP41) are as follows:

1. whilst one can understand that the risks assumed by various institutions can have a significant impact on the economy and society at large, the obligations of directors of companies are long established as fiduciary duties owed to the company itself and in certain cases to its creditors, employees and its shareholders. Seeking to bring in to the equation (if intended) other stakeholders (i.e. the economy and society at large), whilst understandable from a political and prudential perspective, is not appropriate. The law/rules set down by the Oireachtas/ Financial Regulator should be such so as to address general economy/society at large issues rather than those being matters for the Boards of undertakings directly;

2. it is unclear (given the absence of a definition of "Requirements") as to what precisely are the Requirements which have to be met and which have to be addressed in an annual compliance statement, breach of which requires notification within five working days and whose contravention would be an offence;

3. we would query the formal capacity of the Financial Regulator itself (as opposed to the Oireachtas) to introduce new offences (para 2.6) (i.e. breach of the Requirements) and recommend that this particular point be reconsidered as it may require Oireachtas sanction;

4. why would the Requirements not apply to foreign incorporated subsidiaries of an Irish financial institution? Is this because of extra territorial effect, the fact that such foreign incorporated subsidiaries may be themselves regulated in other jurisdictions, may be subject to other legal/regulatory frameworks in those other jurisdictions? Given that large domestic focused financial institutions may have overseas subsidiaries which may contribute significantly to the risk profile of the overall group/parent, we consider that this needs to be reconsidered. It may be the case that identical controls cannot be applied due to local legal/regulatory requirements where the subsidiaries are domiciled but,

nevertheless, we do not think it is sufficient to simply state "institutions are encouraged to adopt equivalent good corporate governance practice in their foreign incorporated subsidiaries", particularly given the issue of associated risk;

5. in para. 4.2 of the Proposal accompanying CP41, a 5 working days notification is imposed. This refers to "a deviation from the Requirements" which in itself seems to be suggesting a breach of the Requirements. If the Requirements are clear (both in terms of which are Requirements and what those Requirements actually require) then one should be considering breaches rather than deviations from the Requirements. In addition, levels of materiality need to be considered and set out. For example:

   (i) could failing to consider all the listed criteria regarding director's independence be a deviation/breach?;

   (ii) will a deviation or breach occur if senior management did not operate "effective" oversight consistent with Board policy and who is ultimately to determine what is or is not "effective"?;

   (iii) para 4.1 indicates that the Board should be "of sufficient size and expertise to oversee adequately the operations of the institution". Who will determine what that "sufficient size and expertise" is? Presumably, it is the Board itself and therefore in what circumstances could there be a deviation/breach?

   (iv) if a Board meeting was held at which the majority of the directors present and eligible to vote were executive directors or if there was an equal number of executive and non-executive directors present and eligible to vote, would that be a deviation/breach potentially triggering an offence?

   (v) how does an institution "ensure a majority of its directors are reasonably available to meet the Financial Regulator at short notice if so required"? If this is to be a strict Requirement it does not seem capable of being actually applied in practice;

   The point we are making is that it needs to be very clear as to what the precise Requirements actually are.

6. certain of the Requirements are worded, in our view, in an incorrect manner albeit that the rationale is correct. For example, in para. 4.4 it provides "each member of the Board shall have sufficient time to devote the role of director and associated responsibilities". Surely this should be a responsibility of the individual Board member and should instead read "a member of the Board should devote sufficient time to his/her role as director and associated responsibilities". In other words, this should be an obligation on the individual, not on the company. (See also para. 4.7 in this regard.);

7. in para. 4.8 reference is made to the Board satisfying itself as to the "appropriateness of the

non-executive director to be a director". No indication is given as to what would or would not be appropriate – does this go to the individual's skill set, prior experience, prior regulatory history, etc. What factors does the Financial Regulator consider meet the "appropriateness" test? Given the vagueness of this type of requirement, how can a deviation or breach be determined and such deviation or breach be considered to be an offence;

Consultation Paper

Section 4.0 Composition of the Board

1. Para. 4 1 indicates that a Board shall have "a majority of independent non-executive directors (this may include the Chairman)" but that two exceptions may apply which, in the context of the focus of our response, would include an institution which is a subsidiary of an entity regulated by "an equivalent competent authority".

   In that case the institution should have a majority of non-executive directors but they need not all be independent but there should be an independent Chairman and a balance between independent and other directors.

   This raises a number of questions as follows:

   (i) what does the Financial Regulator consider to be an "equivalent competent authority"?

   (ii) whilst the majority must be non-executive directors (but do not need all to be independent) it does, nevertheless, require an independent Chairman and a balance between independent and other directors. Therefore, an Irish insurance undertaking which is a subsidiary of a UK regulated insurer would have to have an independent Chairman and a balance between independent and other directors with the majority being non-executive.

   If the Board was made up of 5 persons with the independent Chairman being 1 and being non-executive, of the remaining 4 directors, 2 would have to be non-executive (to ensure that the Board had a majority of non-executives) and depending on how one interprets the word "balance" (either loosely or as equality in number) then 2 of the 4 would have to be independent (with independence itself suggesting non-executive).

   This, however, will again mean the majority will have to be independent non-executive directors so, therefore, it is not a real exception, unless one increases the number of directors over 5.

2. Para. 4.2 notes that the balance between executive and non-executive directors shall be evidenced by the composition of Board members present and eligible to vote at each

Board meeting; the majority of directors present and eligible to vote at all Board meetings shall be non-executives.

If one again takes a Board of 5 persons the majority of whom have to be independent non-executive directors (i.e. 3) and for whatever reason 1 of those non-executives cannot attend a particular Board meeting (due to illness, for example) para. 4.2 would suggest that one of the executive directors who would otherwise be entitled to (and should) be present and eligible to vote at a Board meeting could not attend. That would not be acceptable.

3. Para 4.5. In relation to the numbers of directorships that an individual can hold, again in the context of the Irish subsidiaries of international financial services groups, we note that the maximum of 3 directorships does not apply to multiple directorships within a financial services group. Presumably, therefore, they are counted as 1. Please confirm. What about directorships held in foreign companies - do these count?

4. Has the Financial Regulator compiled a list of the number of Irish based financial institutions to which this limit will apply and, therefore, based on its understanding of the current Board composition of those financial institutions, does the Financial Regulator have data as to:

   (i) the number of individuals who would <u>have to resign</u> directorships to comply;

   (ii) the number of independent non-executive directors that would need to be appointed to comply with the overall Requirements.

   In other words, has the impact of the proposed changes been considered – how many Boards will be affected, how many directors will have to resign, how many new independents will have to be sourced ?

5. Para 4.6 - Should it not be for the individual director to provide the Financial Regulator with detailed rationale and supporting documentation as to why he/she considers that the number of directorships he/she holds does not constitute an inordinate constraint on their time and surely he/she will be best placed to determine that, rather than the institution which seeks to appoint him/her to the Board.

   What about directors who are nominated by shareholders as opposed to by the Board?

<u>Section 5.0 Chairman</u>

1. Para. 5.3 refers to the Chairman having to have a "financial background" or be required to undertake relevant and timely comprehensive training.

What does the Financial Regulator mean by a "financial background" and will it set out what it considers to be "relevant and timely comprehensive training". Does "financial background" require the individual to be an accountant (certified or chartered), to be an actuary (does an actuarial training qualification equate to "financial background"), to have worked in a bank previously, is it based on the individual's prior experience albeit not supported by a professional qualification?

Does it mean that, for example, a lawyer cannot be Chairman of a financial institution nor somebody whose experience is predominantly in the distribution/sale of financial products?

2. In para. 5.6 the Requirement is that the Chairman be an independent non-executive director and similarly any deputy Chairman should also be an independent non-executive.

   In the case of Irish domiciled regulated subsidiaries of international financial services groups, what is the rationale for this requirement? The relevant group, which may have its own ultimate parent company corporate governance requirements imposed by its home / group regulator, may have its own rules in relation to the composition of Boards of subsidiaries which surely should apply. Furthermore, where in particular the principal focus for the Irish subsidiary is not on the Irish market but is on, for example, markets in other EU member states, our experience is that it is extremely important that the Chairman role be available to senior executives from within the parent group in order to ensure support for the Irish subsidiary at all levels within the group, a clear understanding of the operations of the Irish subsidiary and of the associated risks at the highest level within the group, etc. This is often achieved by having the Chairman of the Irish subsidiary being a senior executive from within the group. Whilst that individual may be a non-executive for the purposes of the Irish Board, he/she would not be independent.

3. The requirement in Para 5.7 for the annual election/reappointment of the Chairman of the Board may well be appropriate for domestic institutions with a significant public shareholder base. However, it is not appropriate/meaningful in the context of a wholly owned subsidiary of a foreign financial services group noting, for example, that those that are wholly owned may in fact have disapplied under Irish company law the requirement to hold an annual general meeting at which these types of proposals would normally be addressed. Again, this needs to be reconsidered.

4. We assume most of para. 5.8 should not apply to the Chairman taking on other directorships within the financial services group of which the Irish company is a subsidiary. Please clarify.

In any event, presumably again the Chairman of an international financial services group would be permitted to be Chairman of its Irish subsidiary without breaching this requirement. Please clarify.

Section 6.0 Chief Executive Officer

1. In para. 6.3 there is a requirement for the CEO to have a "financial background" or be required to undertake relevant and timely comprehensive training. The same points arise as under para. 5.3 above - please see comments above in this regard. In the event that an entity has a Chief Financial Officer should/would this make a difference?

2. Para. 6.4 suggests that the renewal of the CEO's contract should occur at least every 5 years. Does that mean, therefore, that the CEO can only be appointed for a maximum of 5 years and that that must be specified in his/her employment contract? Has the impact (cost, succession, willingness of candidates to accept etc.) that this may have on a financial institution been considered?

Section 7.0 Independent Non-Executive Directors

1. The concepts of "independent" and "non-executive" directors are not ones that are clearly designated under Irish company law. Therefore, the distinction between independent directors, non-executive directors and executive directors could be clarified in terms of purpose, duties and obligations. The definitions at page 10 are in our view insufficient in that regard.

   In particular, there will be a necessity on the part of independent non-executive directors to rely significantly on information and reports given to them/produced for them by management and by executive directors (where part of management). This needs to be recognised as otherwise they in effect become executive directors and would be required to act as such.

2. In relation to the Requirements in para. 7.4 and bearing in mind the requirement for a majority of independent non-executive directors, if again one has a Board of 5 members of, for example, an insurance company does this mean therefore that only those with accounting, auditing and risk management knowledge can be appointed and those with actuarial, distribution, asset management, product design and legal skills would be excluded from these appointments.

3. What does "dedicated support" mean in para. 7.5? Does this mean that there has to be a separate secretariat established to support independent non-executive directors? Does that dedicated support have to be able to act independently of management in obtaining information/separate advice for non-executives and what is the proportionality criteria that would be applied to smaller companies?

Section 9.0 Appointments

Para. 9.3 notes that the Board will be responsible for appointing non-executive directors. What about the role of / capacity of shareholders, whether of a public company or of a wholly owned

subsidiary? Surely the shareholders, being the body from which the Board ultimately receives its authority, should be entitled to appoint non-executive directors where they so wish.

Section 10.0 Risk Appetite

1. In para. 10.2 reference is made to "all stakeholders". Who does the Financial Regulator consider to fall within this category?

2. In para 10.4 the requirement that a deviation in the institution's risk appetite measure must be communicated promptly in writing to the Financial Regulator should be a "material" deviation and guidance should be given by the Financial Regulator as to levels of materiality.

3. In para. 10.6 reference is made to the Board ensuring that it receives timely, accurate and sufficiently detailed information from risk and control functions. We do not think that the Board can ensure that.

   The accuracy of the information will be dependant upon the risk and control functions and how they perform their obligations. Unless the Board is itself to perform those risk and control functions, it cannot ensure accuracy of reports from other parties. It can however question the risk and control functions where information provided is not, in the Board's determination, sufficiently detailed and it can take action in the event that it is not receiving information on what it considers to be a timely basis.

4. Again under para 10.7, we are not sure that a Board can ensure that its remuneration practices do not promote excessive risk taking. Looking at the rest of that paragraph, we think that it would be better stated that the Board shall design and implement a remuneration policy which seeks to support a policy of not promoting excessive risk taking and shall evaluate compliance with that policy.

Section 11.0 Meetings

1. The Requirement, again, in the context of subsidiaries of international financial services groups to meet once in each calendar month is, in our view, excessive. Furthermore, having to apply for prior written consent to have a lesser number of meetings per annum suggests that the Financial Regulator is best placed to determine what is or is not disproportionate. Surely it should be for the Board themselves to determine that, not the Financial Regulator.

2. In para 11.3, reference is made to preparation of detailed minutes of all decisions, discussions and points for further actions being documented and with dissents or negative votes being documented in terms acceptable to the dissenting or negative voter. There are many different ways of preparing Board minutes and this ultimately depends on (and

should be left to) the Board members and what they want (both individually and collectively).

Some Boards simply wish to record that particular items have been considered, approved and set out the terms of the decision. Others wish to reflect and summarise the key discussions held. Others wish to have transcribed verbatim the views of directors, including dissents or negative votes (or for that matter agreements or positive votes). Why is the Financial Regulator seeking to dictate how minutes are prepared/drafted ?

We do suggest that following a Board meeting and prior to the Board minutes being finalised (as they are generally not finalised until the next Board meeting at which they are tabled for approval), a "matters arising" list be circulated promptly to the directors for follow-up.

Section 14.0 Committees of the Board

In terms of the membership of the Audit Committee and the Risk Committee (and noting the requirement in para 14.3 that the independent non-executive directors shall play a leading role in these Committees) where one has a Board of 5 persons, a majority of which have to be independent non-executives, the reality would be that 3 independent non-executive directors would be both the Audit and the Risk Committee. We consider that where one ends up with the same persons on both Committees, and where those persons themselves represent a majority of the Board of directors, the proportionality principle should be looked at in this context to determine whether:

(i) there is any point in having such Committees in the first place given the fact that a majority of the Board itself already sits on those Committees;

(ii) whether the Committees can be merged into a single Committee to make it more administratively efficient;

(iii) in terms of the membership and qualifications of Committee members, is the Financial Regulator intending to specify what “relevant expertise and skills” should be in that context.

Section 17.0 Audit Committee

In relation to the Requirements in respect of para 17.6 and the purpose of the Audit Committee, that should (noting Items (a) – (d)) be to report to the Board on the Committee’s review of the financial statements, the financial statements preparation process, the auditor's audit findings report / management letter. However, it is ultimately for the Board as a whole to approve the financial statements and to determine whether they give a true and fair view of the financial status of the institution, not the Audit Committee.

In any event, it is important to ensure that the Audit Committee Requirements will not conflict with other Irish and EU provisions with respect to the establishment and operation of an Audit Committee. In the event of a conflict between the relevant provisions it should be clarified which will prevail.

Section 18.0 Risk Committee

In relation to para 18.5 and the focus on internal capital and loan funds, own funds adequate to cover the risk of the institution, should this not in fact be for management (in particular the CFO) to advise the Board upon.

Section 21.0 Compliance Statement

In relation to the Compliance Statement, directors of life companies are already required to provide an annual compliance statement.

Given that this seems to be an additional requirement in terms of compliance with "these Requirements", we consider that it is extremely important to specify precisely which Requirements the Compliance Statement is to cover and, in particular, to remove any uncertainty / lack of clarity concerning particular Requirements (as outlined above) in order to enable directors to adequately assess whether they have or have not complied.

This comes back in part to determining whether or not what the Financial Regulator considers to be Requirements are in fact rules, principles or a bit of both.

A general statement of compliance with “these Requirements” does not address issues of proportionality and scale as provided within the proposed Requirements. Neither is there any regard to materiality or reasonableness which should also be accommodated in a general requirement of this nature. Care must also be taken to ensure that any new Requirements will take account of the proposed provisions in the draft Companies Consolidation Bill to avoid even more duplication and uncertainty in this area.

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