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Autorité fédérale de surveillance des marchés financiers FINMA  
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# Strengthening Governance and Remuneration Practices of Insurers and Other Financial Institutions: The Role of Supervisors

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- I. Introduction: FINMA
- II. Governance as the Umbrella
- III. Role of Governance in Supervision
- IV. Supervising Remuneration
- V. Ten Challenges for Implementing Supervision of Remuneration

# I. Introduction: FINMA



- As of January 2009: one integrated supervisor
- Born in the middle of the financial crisis
- Crisis helped to bring focus to

➤ *the importance of independent, prioritized and robust supervision*

➤ *the need by companies and supervisors alike to be earlier aware of material risks building up in the financial system or coming or lying across borders*

# Has systemic or contagion risk gone away?



- Mixed economic signals
- A double-dip? Sovereign risk? Currency wars?
- It's not just about risk during crises
- Nor only about “systemically relevant” institutions

- It's about the potential for trust erosion and panic at any time
- It's about the potential of financial services slowing down or freezing up and causing a spill-over on other industries
- Even the best managed of companies would not likely survive a systemic collapse

- Various strategic priorities based on which we are pursuing various initiatives on matters such as:

Improving **macro-prudential supervision** and the supervision of financial **groups**

Developing tools for earlier recognition of **systemic, product, and cross-border risks**

Addressing the “**too big to fail**” challenge,

**Capital and liquidity planning**

Promoting **better governance** among institutions we supervise

## II. Governance as the Umbrella



- It is the fundamental framework
- It is about the orderly allocation of rights and responsibilities...of power
- Without a good governance anchor, the risk management or audit function, for example, could lack sufficient legitimacy and governance power

Our finding: companies who show effort on CG also appear to try to do well on risk management; *good governance seems to plant the seeds for good risk systems and controls.*

- **First point of departure:** *The Board of Directors of each institution, not the supervisor, has first line responsibility for its oversight, including on governance and risk management*
- Board of Director responsibilities include:
  - Ensuring soundness of the company's strategy and risk appetite
  - Supervising management on how well it executes on this strategy and stays within the agreed risk parameters
- Many examples of Boards around the world failing to fulfill this role robustly enough during recent financial crisis

■ **Second point of departure:** *The Board of Directors of a company requires the assistance of independent control functions to carry out its role.*

- Risk Management
- Compliance
- Internal Audit
- Emerging practice: internal controls manager or similar

## BCBS

“A bank should have a *risk management function* (including a chief risk officer (CRO) or equivalent for large banks and internationally active banks), a *compliance function* and an *internal audit function*, each with sufficient authority, stature, independence, resources and access to the board.”

--Principles for Enhancing Corporate Governance 2010

## IAIS

“The Supervisor requires the insurer to have *control functions for risk management, compliance, actuarial matters, and internal audit*, in each case appropriate to the nature, scale, and complexity of the insurer’s business, risks and obligations and with the necessary authority, independence, and resources.”

--draft ICP 8; not final

# OECD Guidelines on Insurance Governance (2010, in consultation)



“The board should establish appropriate **control functions** (including **risk management, actuarial, internal audit, and compliance**) charged with implementing and/or ensuring adherence to, board policies on governance, risk management, internal controls, financial reporting, and compliance, and recommending improvements where necessary. The board should oversee these control functions, including:

- their mandate, scope of activities, authority, independence, and resources;
- their organisational structure, reporting lines, and the relationship among the control functions; and,
- the process for selecting the heads of the control functions.”

# Role of Governance in Supervision (cont.)



■ **Third point of departure:** *Effectiveness and efficiency of supervision necessarily requires the supervisor to have a degree of reliance on (a) the Board of Directors of each institution and (b) its control functions*

■ Hence robust Board of Directors and control functions are in the interest of both companies and supervisors

■ What can supervisors do to promote better boards and better control functions?

■ Are there old practices that had the contrary effect?

# But which approach for supervisors to use?

1. CG not considered in supervision



2. Considered only when problems arise



3. Considered but not regularly or systematically



4. Regular and systematic but isolated



5. Regular/systematic, integrated in ongoing supervision



1. The Supervisor can help companies better govern themselves by making governance a priority, approaching it systematically, and including governance review in its supervisory process.

2. The Supervisor should understand the “governance umbrella”; it should not skip the governance part and go straight to individual risk reviews.

3. Supervisors (and companies) should use as reference point the work of the international standard setters on governance

4. To execute properly on the above, the Supervisor has to have a commitment to governance, which includes having the right capabilities and resources.

- Like governance, not an end of itself
- Why should we care about remuneration?

# Why remuneration is an integral part of governance

- Is a firm managed only through controls? Or also through incentives?
- Remuneration is about incentives.
- Incentives are designed to influence conduct (including risk taking)
- If not properly set, they may influence the wrong conduct

“If any corporate behavior seems irrational, to find out why look at the financial incentives behind it.”

# International Remuneration Initiatives

- **FSB:** we “will periodically review actions taken by firms and by national authorities” on compensation
- **IAIS:** target December 2010
  - Approach: compensation issues are included as part of governance
- **BCBS:**
  - Separate implementation taskforce
  - But compensation also integrated in the revised governance principles: October 2010
- **OECD:** target December 2010
  - Compensation is included in the revised insurer governance principles

# FSB 2009 Implementation Standards

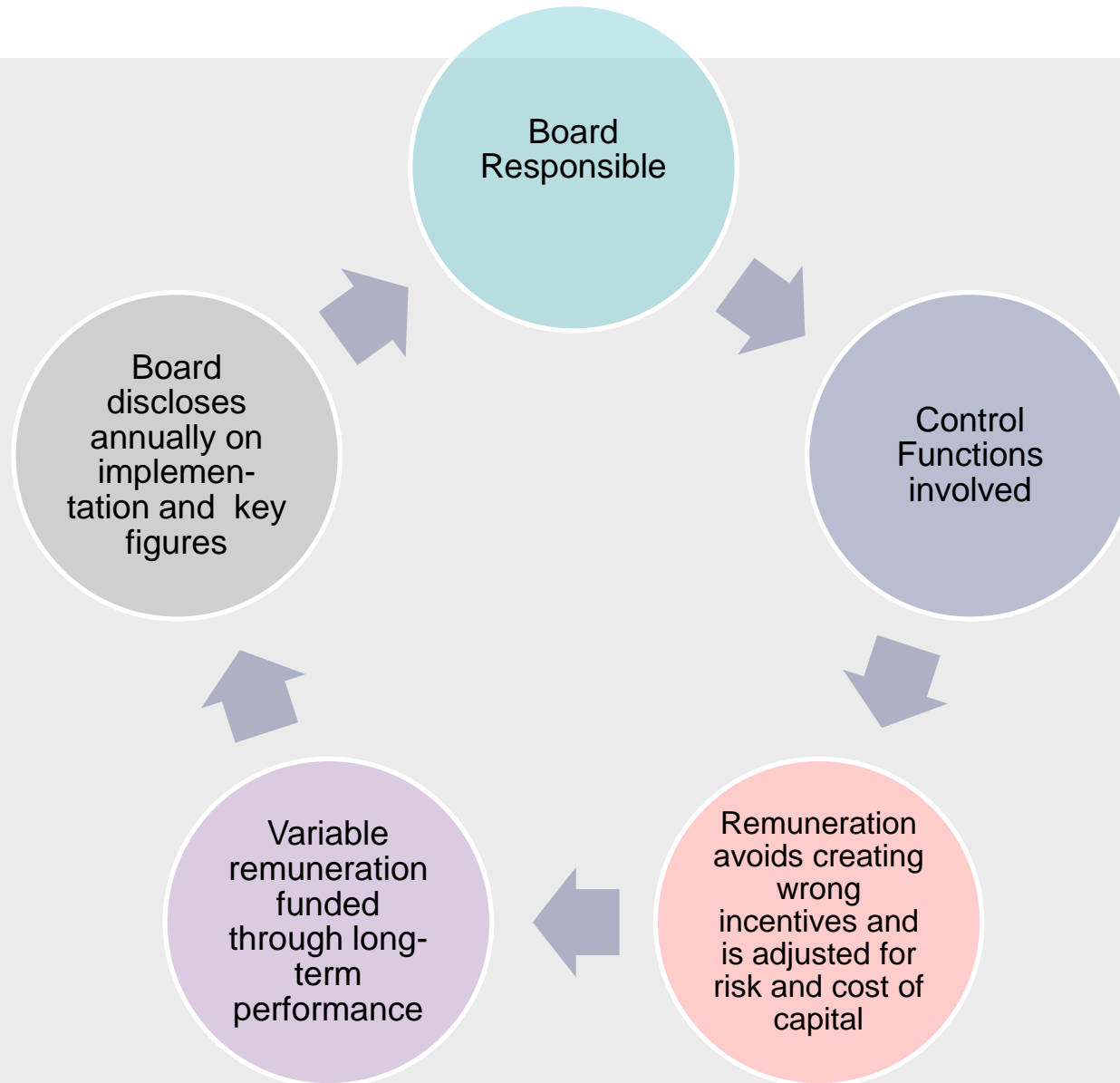


1. Board Remuneration Committee
  - “competent and independent judgement”
  - Annual review of compensation
2. Variable compensation should not weaken capital base.
3. Compensation pool needs to take into account
  - Cost and amount of capital and liquidity risk
  - “timing” and “likelihood” of future profit
4. A “substantial” portion of compensation should be “variable”, “deferred” (“such as 40% to 60%” over three years), and paid in shares (“such as over 50%”)

4. Rest of compensation can be in cash but vest gradually
5. Unvested monies subject to clawback
6. If company receives government help, supervisor should be able to restructure compensation
7. Discourage guarantee bonuses, golden handshakes
8. Annual disclosure

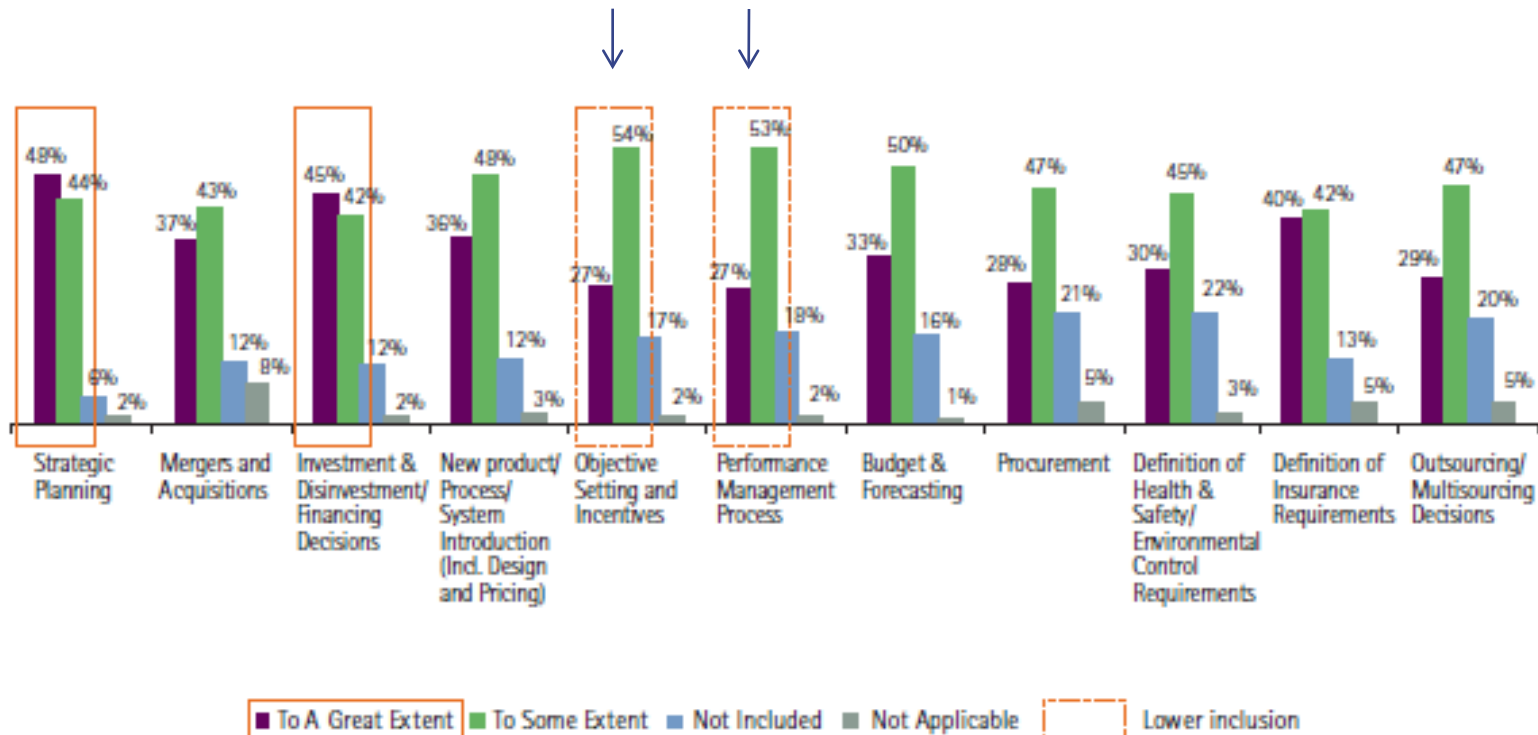
# II. FINMA Approach to Remuneration finma

(simplified)



# Is the risk management function being sufficiently involved on compensation issues?

Figure 5: Inclusion of risk management in decision-making processes.



# Are efforts having an impact on pay?

- Too early to tell...and not all countries have implemented sufficiently
- Some studies suggest bonuses are down, others that they are moving to where they were before the crisis
- But, again, should the amount per se be the primary concern of regulators?
  - In principle only to the extent it affects ability to meet capital and liquidity requirements

# V. Ten Implementation Challenges on Remuneration

1. Principal agent dilemma
2. “We pay our employees for performance”
  - What performance?
  - Whose performance?
  - Over what time horizon?
3. Determining what conduct to incentivize
4. Deferring compensation

5. Post-Award Adjustments
6. Factoring in risk and cost of capital
7. Factoring in qualitative criteria
8. Quality of remuneration governance
9. Unintended consequences
10. The “Risk Taking Dilemma”

A. Supervisors have a very significant role in promoting good governance among companies but need the right capabilities and resources

- It is important to ensure an umbrella approach that covers all elements of governance
- The work of international standard setters on governance is a necessary reference point, also for companies

B. Remuneration is a legitimate topic of governance and hence of supervision: well-governed and determined remuneration is at the heart of good governance and risk control

- Important not to focus not on amounts but on how you get to the amounts
- The numerous practical challenges of implementing remuneration rules or principles require the right supervisory resources, international cooperation among supervisors, and a more even international playing field