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making financial sense of the future

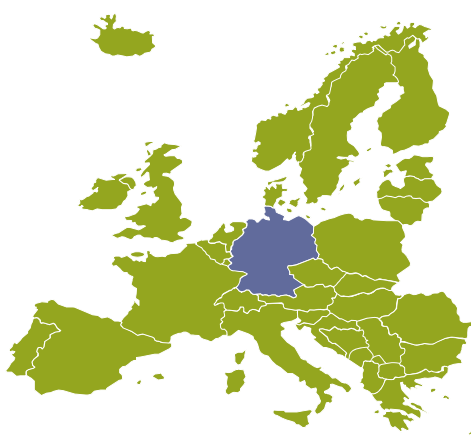
Peter L Devlin – Deloitte Germany  
Stephen Cahill – Deloitte UK

## Risk and Compensation German and UK

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### The view from Germany



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## Workshop agenda

### Germany

- Development of current structure in Germany
- What difference will it make?

### United Kingdom

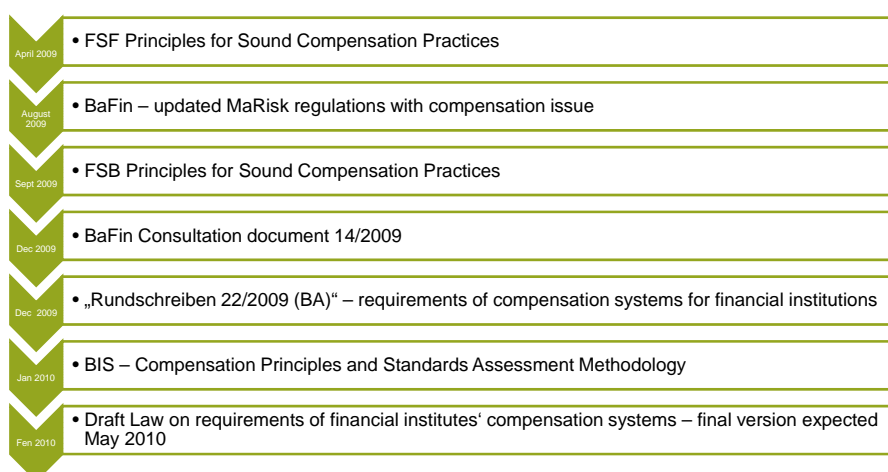
- The UK perspective.

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## Banking: requirements of compensation systems

### Development of current legal structure



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## Banking: key issues

“Compensation must be adjusted for risk”

- Prior to 2008 compensation systems were not related to risk management and risk governance
- FSF report (among others) identified key risk issues:
  - Mix of qualitative and quantitative required
  - Difficulty of incorporating certain risks that are difficult to measure (e.g. liquidity, reputation, cost of capital)
  - Safeguarding the fairness of risk adjustments
  - Danger of distortion of risk measures
- Key issue has been how to deal with “infrequent but large” losses.

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## Financial Stability Board

Issued some guidelines

- Substantial proportion of compensation should be variable
- Paid on individual, BU and firm-wide measures
- 40%-60% of variable should be deferred
- Proportion variable increases with seniority
- Deferral period should not be less than 3 years
- Substantial proportion (50%+) of variable should be awarded in shares or share-linked instruments

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## Bank for International Settlements Principles, Standards & Assessment Methodology

- Which firms? “significant financial institutions”
- Which employees?
  - Material risk-takers, senior management, risk and control functions
  - Groups of employees who take material risks
- “Effective alignment of compensation with prudent risk-taking”
- Supervisory process must be rigorous and sustained
- Engagement of stakeholders

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## Banking: requirements of compensation systems Development of current German legal structure

Risk analysis and self-certification		
Low Risk	High Risk	
<b>General requirements:</b>  Avoid negative incentives  Appropriate compensation for business units  Internal transparency	<b>General requirements:</b>  Avoid negative incentives  Appropriate compensation for business units  Internal transparency	<b>Special requirements:</b>  Variable pay for executives and “risk-takers”  Compensation committee  External transparency

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## Draft BaFin regulations

### Special requirement for executives and risk-takers

- Appropriate mix of fixed and variable pay (not dependent but incentivising)
- Guaranteed variable pay is (generally) not permitted
- Must take account of company, BU and individual results (including non-financial measures)
- Measured on long-term success parameters taking account of risks, capital and liquidity costs
- Claw-back in case of negative results (company, BU, Individual)
- Pay at risk cannot be “replaced” by other measures
- Minimum thresholds for payout (see example)

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## Design of variable pay

### Minimum requirements

Structure of “Risk Taker”			Pay-out period			Requirements of deferral		
Group	Fixed Pay	Bonus (% of fixed)	„Deferral” part	„Deferred” Bonus	Direct Payout	Part reliant on co’ value	Independent of company value	Company dependent
1	300.000 €	210.000 € 70%	60%	126.000 €	84.000 €	70%	37.800 €	88.200 €
2	250.000 €	125.000 € 50%	50%	62.500 €	62.500 €	60%	25.000 €	37.500 €
3	200.000 €	60.000 € 30%	40%	24.000 €	36.000 €	50%	12.000 €	12.000 €
4	150.000 €	30.000 € 20%	N/A	0 €	30.000 €	N/A	0 €	0 €
5	100.000 €	10.000 € 10%	N/A	0 €	10.000 €	N/A	0 €	0 €

60% of total bonus in cash at end of measurement period

20% in 3 equal parts over 3 years

20% at the end of deferral period (stock related)

#### Deferred Pay-out (Group 3)

Payment period	Period				Pay-out conditions
	t0	t1	t2	t3	Requirements
“Non-deferred”	36,000 €	-	-	-	- Service in Period t-1
“Deferred” bank value dependent	0 €	4,000 €	4,000 €	4,000 €	- Service in Period t-1 - positive P&L contribution in following year (otherwise Malus)
“Deferred” bank value independent	0 €	0 €	0 €	12,000 €	- Service in Period t-1 - positive P&L contribution in following year (otherwise Malus) - positive development in bank value

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## Additional requirements of quoted companies VorstAG

### VorstAG

- “Appropriateness” of pay
- Cap for variable pay
- Four year vesting period for stock options
- Liability for non-appropriate pay
- Reduction of payment in case of reduction in worth of the enterprise and restructuring of company
- Non-binding resolution at AGM
- Requirements on public information

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## Additional requirements of quoted companies Deutsche Corporate Governance Kodex

### DCGK

- Vertical benchmarks
- Take account of negative developments
- No incentives for excessive or inappropriate risk-taking
- Use of independent external compensation expert

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## Germany: will all the new regulations have the desired effect?

### BaFin draft (formerly MaRisk)

- Very few banks will declare themselves as “High Risk”
- Will financial institutions move down to the minimum of regulator?
- Would the new regulations have stopped the banking losses of the previous 3 years?
- BaFin requirements on public disclosure likely to be biggest driver of change

### VorstAG

- Open to interpretation (for example “appropriate” was not defined)
- Will require a few court cases to clarify

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## The UK Perspective



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## Regulatory landscape

- The FSA is responsible for implementing the Principles for Sound Compensation Practices issued by the FSB
- Issued Remuneration Code, effective 1 January 2010
- A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.
- Broadly applies to:
  - UK bank or building society that had capital resources exceeding £1 billion on its last accounting reference date; or
  - the firm is a BIPRU 730k firm that had capital resources exceeding £750 million on its last accounting reference date.

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## Key risk issues identified by the FSA

Excessive focus  
on short-term  
results

Failure to take  
account of  
current / future  
risks not  
reflected in  
performance  
measurement

Conflicts of  
interest for risk  
function

Insufficient  
weight given to  
non-financial  
measures of  
performance

Cash bonuses  
with no/minimal  
deferral

Lack of long-  
term alignment

Revenue based  
bonus pools

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## The FSA Remuneration Code

- The Code seeks to address the link between remuneration and risk through one general Rule supported by eight Principles
- Each Principle is backed up by more detailed guidance
- The Principles are summarised below:

General Rule	<i>A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.</i>	
Principle 1	Role of bodies responsible for remuneration policies and their members	<p>A remuneration committee should:</p> <ul style="list-style-type: none"> <li>• exercise, and be constituted in a way that enables it to exercise, independent judgment</li> <li>• be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects</li> <li>• have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management</li> <li>• be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness</li> </ul>
Principle 2	Procedures and risk and compliance function input	<ul style="list-style-type: none"> <li>• Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest</li> <li>• A firm's risk management and compliance functions should have appropriate input into setting the remuneration policy for other business areas.</li> <li>• The procedures for setting remuneration should allow risk and compliance functions to have significant input into the setting of individual remuneration awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken</li> </ul>

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## The FSA Remuneration Code, continued

General Rule	<i>A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.</i>	
Principle 3	Remuneration of employees in risk and compliance functions	<ul style="list-style-type: none"> <li>• Remuneration for employees in risk management and compliance functions should be determined independently of other business areas</li> <li>• Risk and compliance functions should have performance metrics based principally on the achievement of the objectives of those functions</li> </ul>
Principle 4	Profit-based measurement and risk-adjustment	<ul style="list-style-type: none"> <li>• Assessments of financial performance used to calculate bonus pools should be based principally on profits</li> <li>• A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required</li> </ul>
Principle 5	Long-term performance measurement	<ul style="list-style-type: none"> <li>• Where the performance-related component of an employee's remuneration is a significant part of his total remuneration, the assessment process should be designed to ensure assessment is based on longer-term performance</li> </ul>
Principle 6	Non-financial performance metrics	<ul style="list-style-type: none"> <li>• Non-financial performance metrics should form a significant part of the performance assessment process</li> <li>• Non-financial performance metrics should include adherence to effective risk management and compliance with the regulatory system and with relevant overseas regulatory requirements</li> </ul>
Principle 7	Measurement of performance for long-term incentives	<ul style="list-style-type: none"> <li>• The measurement of performance for long-term incentive plans, including those based on the performance of shares, should take account of future risks</li> </ul>
Principle 8	Remuneration structures	<ul style="list-style-type: none"> <li>• This evidential provision and guidance on remuneration structures apply in relation to:               <ol style="list-style-type: none"> <li>1. a person who performs a significant influence function for a firm; and</li> <li>2. an employee whose activities have, or could have, a material impact on the firm's risk profile.</li> </ol> </li> <li>• A firm should ensure that the structure of remuneration for a person to whom this evidential provision applies is consistent with and promotes effective risk management</li> </ul>

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## Financial Services Act 2010

- Enacted 8 April 2010
- The Financial Services Act gives wide-reaching powers to the FSA to support the Remuneration Code, including the ability to:
  - require firms to have a remuneration policy consistent with the FSB Principles
  - make rules which prohibit persons ... from being remunerated in a specified way
  - make void any provision of an agreement that contravenes such a prohibition
  - claw back payments made under remuneration deemed as void
- The Act also gives powers to the Treasury on what has to be included in remuneration reports, how information should be set out and what part of the report is auditable
- The proposed regulations in particular include the following disclosure requirements:
  - the number of “relevant executives” whose remuneration in the preceding financial year exceeded £500,000
  - disclosed in bands of £500,000 up to £5m and thereafter in £1m bands
  - such remuneration to be broken down into salary, fees, expenses, bonuses, long-term incentive awards, share options and pension contributions

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## What does this mean in practice?

“The FSA’s supervisors will be testing rigorously whether firms’ risk management and governance arrangements are in practice delivering the right outcomes”

***FSA Turner Review***

- Not a box-ticking approach
- Regulators seeking to embed firm-wide risk management and risk governance processes and frameworks
- Significant increase in the scope and role of risk
- Considerable work required to address the new challenges

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## Wider Corporate Governance framework (Applies to all UK listed companies)

### Legislation and regulations

- Publicly listed companies are required by law to disclose in their annual reports certain details around executive remuneration, including amounts paid in the last year and the policy behind executive pay
- Shareholders have an advisory vote on the remuneration report at the AGM
- Shareholder approval is required for new long-term incentive plans.

### Combined Code (to be renamed the UK Corporate Governance Code) Financial Reporting Council

- A set of principles of good corporate governance which provide a code of best practice for listed companies
- Listing Rule requirement that companies disclose how they have complied with the code, and explain where they have not applied the code

### "Best practice" guidelines

Association of British Insurers (ABI)  
RiskMetrics  
Pension and Investment Research Consultants Ltd (PIRC) (and others)

- Recommended best practice guidelines published by institutional shareholder bodies
- No requirement to comply, although typically used as a template by shareholders in assessing the appropriateness of remuneration policies
- ABI and RiskMetrics are the most influential.
- Other organisations also provide comment (e.g. PIRC) but these generally have less weight in practice.

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