3 August 2015

# FSB-IAIS 2015 Workshop on compensation practices in the insurance sector

## Washington, 12 May 2015

The Financial Stability Board (FSB) organised on 12 May 2015, jointly with the International Association of Insurance Supervisors (IAIS), the first workshop on compensation practices in the insurance sector. The objective of the workshop, as noted in the November 2014 FSB progress report, was to provide an overview of the current remuneration practices at insurers and to promote interaction and encourage the sharing of experiences and views on the implementation practices and challenges of the FSB *Principles* and *Standards* for Sound Compensation Practices (P&S) by insurers. The workshop focused on various elements of sound compensation policies, including the governance of compensation, alignment of compensation with prudent risk-taking, and the role of compensation in supporting a sound risk culture at insurers.

Members from the FSB Compensation Monitoring Contact Group and from the IAIS Governance Group as well as twelve senior executives responsible for remuneration and risk management at internationally active insurance groups participated in the workshop. A workshop on compensation practices with global systemically important banks was held in April 2015 and the key takeaways are published on the FSB website.

This summary reflects regulators' understanding of the main points raised in the discussion at the workshop. It does not necessarily represent the views of authorities nor consensus views expressed by insurers at the workshop. Workshop findings will be included in the next FSB progress report on compensation practices, which will be published in advance of the G20 Summit in November 2015.

The FSB welcomes any feedback on topics discussed at the workshop and summarised in this note. Comments should be sent to fsb@bis.org **by 31 August 2015**.

## Key takeaways

### 1. Implementation of the FSB Principles and Standards in the insurance sector

Participants discussed the applicability of the FSB P&S to the insurance sector. While the general perception was that the principles were primarily developed to address compensation practices in the banking sector, participants noted that risk alignment of compensation is a common practice in the insurance industry. Insurers remarked that the P&S are implemented in many jurisdictions, but that national requirements often differ. It is a challenge, especially for the parent company of an insurance group, to develop a group-wide policy that at the same time complies with all local requirements.

Industry participants expressed a view that compensation practices and the specific nature of business activities at insurers differ significantly from those of banks – in particular, insurers noted:

- Insurer groups that do business internationally are subject to different regulatory regimes worldwide that make the implementation of global compensation policies very challenging.
- There are important differences between the business model of banks and insurers, driven in part by the fact that insurers are exposed to longer term investment horizons.
- Insurers and their staff are traditionally more conservative and have longer career horizons than in banking. What motivates people in the insurance industry is often different than in banking. Insurance staff are more oriented toward career employment and short-term compensation is less of a driver.
- Insurance companies generally identify fewer material risk takers (MRTs). Roles that influence capital and its consumption are key to identification of MRTs.
- Generally, both the quantum of pay and use of variable compensation is lower at insurers than at banks. The staff cost in the insurance sector is significantly lower as a percentage of total revenues than in the banking sector.
- Compensation systems are more structured for insurers and the use of discretion is less prevalent, although compensation practices in some areas of operation, such as asset management activities, may be relatively more similar to that of banks.
- The longer term business and risk horizon, both in terms of career and compensation arrangements, imply fewer reasons for the use of malus and claw backs.

Participants discussed at a high level the objectives of compensation policy in the insurance industry. They emphasized the importance of sound risk management and a focus on internal controls. A key objective is designing compensation structures that align with the firm's long term strategy and risk management horizon. The importance of setting appropriate targets was also stressed. However, creating reasonable targets (for instance, in the area of customer satisfaction) that take into account the longer term nature of products such as life insurance is challenging. One participant suggested that considering pension benefits schemes as part of rewards could bring more stability to compensation and possibly more consistency across jurisdictions, since amounts can be quite significant and pension is by definition a long term element of the overall compensation plan.

Another objective of compensation policies is to attract and retain staff. Insurers expressed a view that the ability to attract employees outside the traditional recruiting base was critical to adapting to the changing competitive landscape. Attracting and retaining staff given competition from non-financial sectors for data analysts, marketing experts and information technology staff is a challenge. For example, it is harder to attract people with critical technical skills when sectors such as pharmaceuticals or technology firms offer comparable (if not higher) level of pay and are not subject to the same level of regulation.

Participants also noted that other stakeholders, such as institutional investors or proxy holders, can affect compensation practices. Some insurers remarked that generally institutional investors prefer simple, formulaic compensation structures that make it easier for investors to understand and oversee compensation awards and less discretion. However, insurers feel the need to retain a certain degree of flexibility in order to better reflect differences in performance.

## 2. Governance of compensation practices and their role in supporting a sound risk culture at insurers

Participants noted that Boards, in particular independent directors, the Chief Risk Officer (CRO) and the risk management function play a significant role in the design and control of compensation system and are nowadays much more involved in the development of compensation policies. Risk and remuneration sub-committees often synchronise agendas, and have joint meetings and overlapping membership. Many boards also engage independent remuneration consultants to advise them on compensation matters. Consultants are able to review all reports going to the board and to interview executives as necessary. Typically, CROs are involved in reviewing compensation plans' design and structure, as well as individual compensation arrangements for senior executives and other 'purview employees' (i.e. employees who receive higher levels of Board oversight).

Participants shared the view that effective risk management is key for insurers, and that compensation should not be considered in isolation but instead within the broader risk management framework. An effective link with risk management is considered the most important factor driving compensation, with the risk management function playing a prominent role in identifying key risk takers and material risks. The use of risk-adjusted measures can present challenges, however, because they are not usually audited and minor adjustments can have large effects. It is generally preferable to use measures that that are effectively used for business purposes, for example measures that are used for pricing purposes. Participants emphasized the need for a balance between using performance indicators and focussing not only on or outsized risk, but also on "stretch" targets.

When aligning compensation and prudent risk behaviours, it is a common practice to adopt a two-step process that considers 'the what' (or output delivered such as profit, growth etc.); and 'the how' (qualitative aspects of performance including risks created, conduct, reputation etc.). Some insurers use a 'risk modifier' approach that adjusts compensation based on material risk outcomes together with qualitative measures related to customer satisfaction, for example, all of which impact overall bonus funding.

A few insurers have developed processes to verify that the firm's compensation arrangements are achieving intended results, with the CRO and risk management function reviewing or "back-testing" plan outcomes, as well as considering "compensation risks" from compensation design in terms of incentives for excessive risk taking. In a few cases, the risk management function will target potential 'hot spots' (e.g. a rapidly growing business line or third-party distributors) to assess whether compensation practices are having an unwanted impact.

The use of compensation as a proactive tool to promote or ensure good behaviour was also discussed. As indicated above, many participants noted that career prospects, rather than bonus decisions, had the more material impact on behavioural aspects (especially for market conduct). Some insurers expressed the view that it is more effective to prevent bad behaviour than to correct it afterwards by paying out a lower variable compensation.

Participants noted that the “tone at the top” is one of the most powerful tools to impact behaviour, as well as ensuring that the right monitoring and control systems are in place. However, participants acknowledged that compensation can also be used as a tool to impact behaviour. Ex post adjustments are seen as more powerful signalling devices than ex ante adjustments (assuming the same “quantum’ of adjustment). Clawback clauses are commonly attached to variable remuneration packages, and their use is generally associated with termination for cause or in cases of material financial restatements. Clawbacks are considered more as “moral clauses” rather than effective tools, since legal enforceability is seen as a challenge and there is no evidence of their application and effective use.