

skandia :

validation of risk analysis in
relation to remuneration
system and remuneration
policy in Skandia

Validation of Risk Analysis in relation to remuneration system and remuneration policy in Skandia

Introduction

New regulations require financial institutions to establish a remuneration policy and to conduct a risk analysis in respect of the policy. Before a decision is made on the remuneration system or other material changes in the system, a risk analysis shall be conducted of how the system affects the risks that Skandia Insurance Company Ltd (publ) ("Skandia") including its subsidiaries in the Nordic countries ("Skandia Nordic") are subject to and how these risks are managed, hence this document.

Skandia's risk analysis covers a description of the Risk management and control system in Skandia, principal risks categories (including reputational risk), remuneration system, risk tolerance and risk analysis based on the remuneration policy, remuneration system and the process for selecting risk takers. The main focus in the analysis is on the variable remuneration.

Risk Management and Control in Skandia

Principal risks in Skandia

Skandia currently conducts unit linked assurance business including supplementary insurance, such as waiver-of-premium insurance and some property and casualty insurance business (private healthcare insurance and accident insurance). In addition, Skandia has support services that are associated with its insurance and advisory activities. Furthermore, Skandia has, via its subsidiaries, bank business and fund management business. Skandia's business gives rise to a broad spectrum of risks that could potentially impact Skandia's operating result and financial position. Some of these risks are natural consequences of the business unit's business and are conscious risks. Other risks are not an expression for any conscious risk-taking.

Skandia's main risks relate to operational, strategic, business, compliance, reputational risks as well as financial risks (i.e. credit, liquidity, market and interest risks). The market risks mainly relate to asset-based income which reduces when the value of the unit-linked funds declines. Having a diversified product range and a wide range of investment options addresses some of the market risks. Risks arising from operating experience (e.g. persistency and management expenses) are managed through the risk framework which includes a three-lines-of-defence model (see 2.2 Three lines of defence model) and risks exceeding pre-defined risk tolerance levels are escalated to firstly Skandia's Chief Risk Officer ("Skandia CRO") and then to Old Mutual Group Chief Risk Officer. Political and regulatory changes which could have an impact on the businesses are continuously monitored and managed.

Three lines of defence model

Skandia uses its parent company's, Old Mutual Plc ("OM"), Enterprise Risk Management methodology for managing and controlling risks. According to this methodology, formal governance structures are complemented by a risk governance model based on "three lines of defence". This model distinguishes between the functions that own and manage risks and compliance (the first line), the functions that oversee risks and compliance (the second line), and the functions for independent review that provide independent assurance (the third line).

What it covers:

What it covers	Executive		Non-executive
	<i>First line</i>	<i>Second line</i>	<i>Third line</i>
	<ul style="list-style-type: none"> • Strategy • Tone at the top • Code of conduct/risk tolerance • Risk prediction and avoidance • Risk management and reporting • Compliant and risk-aware operating practices • Performance management 	<ul style="list-style-type: none"> • Clear and well communicated risk policies • Effective control and monitoring systems • Independent risk and compliance oversight, control and challenge • Assist with advisory support 	<ul style="list-style-type: none"> • Independent assurance and oversight

Responsibilities:

Responsibility and roles	Executive		Non-executive
	<i>First line</i>	<i>Second line</i>	<i>Third line</i>
	RESPONSIBILITY 1. Board of directors 2. CEO 3. All employees ROLES Risk owners Risk & Compliance coordinators	RESPONSIBILITY1 1. Board of directors 2. CEO 3. Nordic Independent Risk & Compliance Control (IRCC): <i>Head of IRCC</i> <i>CRO legal entities</i> <i>COO legal entities</i> <i>IRCC contact persons per unit</i> <i>Chief Actuary</i>	RESPONSIBILITY 1. Board of directors 2. Audit committee 3. Internal Audit 4. External Auditors

On 1 January 2009, SICL centralised all functions working with oversight/control into one function; Skandia Nordic Risk & Compliance Control (“IRCC”). This was done in order to improve the independent status in relation to first line of defence but also to harmonise the oversight/control processes in Skandia Nordic. In relation to the different legal entities, there are outsourcing agreements in place in relation to this function. In order to implement the common processes in the whole of Skandia Nordic, the Skandia Nordic Risk & Compliance framework (available upon request in Swedish) was created and communicated early 2009 to the first line of defence. Furthermore, the policy “Governance and internal Control” describes Skandia’s Board’s fundamental instruments for business governance and good internal control.

Additionally, the department Skandia Nordic Business Control & Support (“BCN”) is responsible for conducting a quantitative assessment of the risks that exist in Skandia and their impact on financial position, and report these values to the Head of IRCC (also Skandia CRO) and Skandia’s CFO. Further, BCN manages the Risk Appetite framework. The framework has been developed by Skandia’s parent company, OM. Skandia’s Risk appetite defines the boundary of acceptable risk and hence losses. Skandia Nordic uses four quantitative measures that OM uses to express its Risk Appetite limits and exposure, namely Capital at Risk (CaR), Earnings at Risk (EaR), Cashflow at Risk (CFaR) and Operational Risk (OpRisk).

Analysis of Skandia's remuneration system

Remuneration policy

On 19 February 2010 a remuneration policy, based on the Swedish Financial Supervisory Authority's (Sw. Finansinspektionen) ("Swedish FSA") General Guidelines governing remuneration policies for insurance companies, stock exchanges, clearing organisations and institutions for the issuance of electronic money (FFFS 2009:7) ("the General Guidelines"), which shall be applied by Skandia and its subsidiaries in the Nordic countries (with the exception of Skandia Life Insurance Company Ltd (publ) ("Skandia Liv") which has adopted its own remuneration policy), was approved by the Skandia Board. For Skandiabanken Aktiefbolag (publ), Skandia Fonder AB and Svenska L rarfonder Aktiefbolag, corresponding regulations exist, such as in the Regulations and General Guidelines governing remuneration policies in credit institutions, investment firms and fund management companies (FFFS 2009:6). The policy, which was adopted by the Skandia Board, applies for all remuneration of all employees in Skandia Nordic, except for in cases where subsidiaries may have adopted stricter rules or otherwise other more specific rules that are motivated by their own operations or similar. By all remuneration is meant remuneration and compensation including benefits that Skandia Nordic pays out directly or indirectly to a person within the framework of employment. Remuneration does not include commission based salary with no connection to such future risk undertakings that can change the company's profit and loss account or balance sheet. The policy also states that Skandia should have a Remuneration Committee tasked with preparing essential matters regarding remuneration of employees of Skandia Nordic, with the exception of Skandia Liv, which has its own remuneration committee.

The policy contains in short:

- Fundamental principles for employee remuneration
- Components and composition of remuneration
 - *Variable remuneration*
 - *Lock-in of variable remuneration*
- Remuneration of persons in control bodies
- The policy in total is to be found in the Skandia Nordic Corporate Manual.

Remuneration system in Skandia

The components and composition of the remuneration are as follows:

- Monthly salary, i.e., a fixed salary that is paid out monthly
- Bonus (incentive), which pertains to remuneration based on results, i.e., performance-based remuneration (or based on financials). As a rule, such remuneration is paid out yearly based on performance in relation to expectation. One part of the basis for the variable pay is a risk-adjusted metric that is under development *).
- Skandianen is a profit-sharing foundation (however, not a foundation as defined in the Foundations Act (Stiftelselagen [1994:122]) or Pension Obligations Vesting Act (Tryggandelagen [1967:531])). For employees who are not entitled to a bonus, a yearly allocation is made to Skandianen based on Skandia Nordic's financial result
- Pension and risk insurance
- Other benefits

*) N.B. currently OM is developing a risk adjusted metric, i.e. the Economic Profit (EP) metric that will be used for, among other BU's, Skandia Nordic in 2010 as a soft trial metric for the executive bonus pool. The following years it will be further developed, hence be implemented as a hard measure when completely in place. The EP metric is risk adjusted because it assumes that we will always hold capital which is at least equal to a risk-based capital requirement (i.e. EC).

Risk analysis

Remuneration system versus remuneration policy

If there are any risks in relation to the remuneration system, the largest risk would be on the bonus (incentive) part, i.e. the variable pay. However, taking the following information from the remuneration policy, into consideration, together with the assumption that the Risk management and control system is followed, IRCC does not at this point see any risks related to the remuneration system connected to the remuneration bonus (incentive) based on the following criteria in the remuneration policy:

- With respect to variable remuneration, a cap is in place which indicates the maximum level of remuneration that can be paid if all targets are exceeded. The cap is set in advance.
- Remuneration systems encourage long-term value creation for Skandia Nordic with a well-balanced risk horizon.
- The results that form the basis of decisions on variable remuneration include an assessment of whether the results are sustainable even during an economic downturn.
- There is a suitable balance between the fixed and variable components.
- For employees who exercise or could exercise significant influence over Skandia's risk level ("Risk takers"), payment of a minimum of 60 per cent of the variable remuneration is deferred for at least three years.
- For Risk takers, the Board has the right to unilaterally void the right to payment of the deferred remuneration in the event of such extraordinary circumstances that entail that the company's financial stability is threatened or if a wrongdoing is committed in such way that the performance criteria have not rightfully been met. The vesting period or, alternatively, the date for final earning of remuneration that is provided in the form of equities, equity-related instruments or other financial instruments, are at least three years.
- Additionally, if employees who work in a review capacity for operations, such as employees in IRCC and Internal Audit, are to be subject to a variable pay such as bonus (incentive), the basis is independent of the areas they control.
- The remuneration policy for Skandia Nordic must be reviewed yearly, so that it evolves in pace with changes in the company's situation.
- Auditors' control that the performance criteria have been met

Furthermore, Skandia has a clear governance and approval process for all remuneration components in Skandia, including the Grandfather principle, a Remuneration Committee and by having most remuneration paid as fixed salary.

However, risks related to the variable pay process governed by the remuneration policy exist and will continue to exist (e.g. fraud, process failures, reputational etc) going forward. Skandia applies a wide range of processes, tools and control activities to manage the risks and thereby reduce potential negative effects.

Analysis of the process for selecting Risk takers

The definition of Risk taker has been based on the Swedish FSA's written statement in the General Guidelines, Chapter 1. In general a Risk taker is an employee who substantially can affect Skandia's risk level. According to the definition, the following employee categories are to be seen as Risk takers:

- Employees in top management positions
- Employees in control functions
- Employees in leading strategic positions (e.g. head of business area)
- Traders/brokers on the capital market
- Employees responsible for credit granting
- Employees responsible for the granting of credits (e.g. members of a credit committee)

The process used for identifying Risk takers within Skandia has included the following steps:

- Interpretation of the Swedish FSA's regulations and guidelines, in the light of Skandia Nordic's operations and fundamental conditions
- Review of all relevant risk areas from the above interpretations
- Registration of potential Risk Takers (positions)
- Co-ordination with representatives from operations/management
- Co-ordination with peers
- Review performed by representatives from Skandia Nordic Risk & Compliance Control function and Legal department
- Review performed by Novare Compensation in order to get a "second opinion"
- Final decision through an approval of a register of Risk takers by the Remuneration Committee
- A Remuneration Committee report to Skandia's Board of Directors in conjunction with approval of the Annual Report

The group of Risk takers identified will be subject to change on-going by Skandia, hence the composition of Risk takers might differ from time to time, in the light of the effect they might have on the Skandia Nordic risk level.

IRCC note that Skandia has complied with the Swedish FSA's definition of a Risk taker (from the General Guidelines, Chapter 1) when making a register of Skandia's Risk takers. Furthermore, when Skandia has chosen to not include a specific position as a Risk taker Skandia has described the reasoning behind this decision. Taking this process into consideration, IRCC does not see any further need to include further Risk takers at this point.

Maximum effect of remuneration system in relation to the budgeted Skandia result for 2010

IRCC has performed a basic analysis according to the following:

Maximum outcome for all employees who has a variable pay part in their remuneration package (i.e. Skandianen + variable pay) *in relation to* the budgeted IFRS pre tax result for Skandia.

IRCC deem the variable pay share reasonable, hence a low risk of the current remuneration system to destroy value in Skandia.