EIOPA Consultation Paper on the Proposal for Guidelines on the System of Governance

April 2013

EIOPA's Consultation Paper on guidelines to regulators for the implementation of the System of Governance requirements under Solvency II closely mirrors the guidelines previously released through the Level 3 pre-consultation process.

INTRODUCTION

On 27 March 2013, the European Insurance and Occupational Pensions Authority (EIOPA) launched a consultation on guidelines for the preparation for Solvency II. The purpose of the consultation is to *"support both National Competent Authorities (NCAs) and undertakings in their preparation for the Solvency II requirements"* with the aim of ensuring a consistent and convergent approach in preparations.

The consultation covers guidelines for the phased introduction of specific aspects of the Solvency II requirements into national supervision from 1 January 2014, in advance of the full implementation of the Solvency II regime. The guidelines are set out in four consultation papers and accompanying explanatory text covering:

- System of governance
- Forward-looking assessment of the undertaking's own risk (based on Own Risk and Solvency Assessment (ORSA) principles)
- Submission of information to NCAs
- Pre-application for internal models

The consultation will run until 19 June 2013 with final guidelines expected to be published by EIOPA in autumn of this year.

To assist you in digesting these consultation papers, Milliman has prepared a series of summary papers covering each of the consultation papers separately. This summary paper covers the guidelines on the System of Governance.

OVERVIEW OF GUIDELINES FOR NCAs REGARDING THE SYSTEM OF GOVERNANCE

EIOPA's proposed guidelines set a framework for NCAs to ensure that firms are implementing the Pillar 2 requirements relating to the System of Governance in accordance with the Solvency II Directive. The guidelines are wide-ranging in scope but reflect those informally discussed with stakeholders as part of the Level 3 pre-consultation process in 2011.

The guidelines are grouped in broad themes:

- General Provisions for preparatory Guidelines (Guidelines 1-2)
- System of Governance relating to:
  - General Governance Requirements (Guidelines 3-10)
  - Fit and Proper (Guidelines 11-14)
  - Risk Management (Guidelines 15-24)
  - Prudent Person (Investment Management) (Guidelines 25-30)
  - Own Funds Requirements (Guidelines 31-32)
  - Internal Controls (Guidelines 33-34)
  - Internal Audit Function (Guidelines 35-39)
  - Actuarial Function (Guidelines 40-47)
  - Outsourcing (Guidelines 48-51)
- Group Governance Specific Requirements (Guidelines 52-57).

As set out in EIOPA's opinion paper, published in December 2012, NCAs are expected to comply with the guidelines by ensuring firms meet the specified outcomes. As such, NCAs will have two months following the issue of the finalised guidelines to explain whether they currently comply, how they intend to comply, or why they do not intend to comply with the guidelines. NCAs will have to submit annual progress reports on the application of the guidelines by the end of February each year (with the first report due to be submitted 28 February 2015).

EIOPA has stressed that the guidelines do not require NCAs to take supervisory action in relation to any of the outcomes from the requirements, particularly where these may reflect a failure to comply with Solvency II Pillar 1 requirements. The guidelines are intended to be applied by NCAs in a proportionate manner and allow for flexibility in application through provisions for “phasing-in”.

In particular, EIOPA has noted that in respect of the guidelines relating to the Prudent Person and Actuarial Function requirements, the intent is to ensure that governance arrangements are in place rather than that investment portfolios or the calculation of technical provisions satisfy Solvency II requirements.

EIOPA’s opinion paper, published in December 2012, set out the intention that firms would be required to put in place “an effective system of governance which provides for sound and prudent management of the undertaking and an effective risk management system including a forward looking assessment of the undertaking's own risks (based on the ORSA principles)”. This opinion has been interpreted by many to relate to the implementation of the governance elements and to focus on the qualitative assessment of risk.

The scope of the guidelines to NCAs in respect of the System of Governance appears to be consistent with this intent and seeks to ensure that firms have implemented or are capable of implementing the Solvency II governance framework by the official implementation date.

We do not expect that the application of these guidelines will have a material impact on UK firms as we believe that most UK firms will have already covered much of the journey to Solvency II set out in these proposals and that the proposals reflect typical current practice for UK firms.

OVERVIEW OF GUIDELINES

The consultation paper on the System of Governance sets out 57 guidelines aimed at NCAs to ensure firms actively prepare to apply the System of Governance requirements of the Solvency II Directive. In this section we briefly outline the scope of the guidelines.

General Provisions for Preparatory Guidelines (Guidelines 1-2)

Guidelines 1 and 2 provide the framework for NCA’s to implement the preparatory guidelines. The aims are stated to be that NCAs should ensure firms and groups take appropriate steps to build:

- An effective System of Governance
- An effective risk management system with strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis and at an individual and at an aggregated level, the risks to which they are or could be exposed, and their interdependencies
- Qualitative information supporting the System of Governance

System of Governance

As noted above, the guidelines addressing the detailed requirements are grouped by themes.

General Governance Requirements (Guidelines 3 -10)

Under the proposed guidelines, NCAs are required to ensure that:

- The administrative, management or supervisory body (AMSB) (whether at solo or group level) is engaged with the management process
- The organisational structure established by the AMSB maintains an adequate segregation of duties, is proactive and challenging, supports the strategic objectives and operations of the firm and is capable of being adapted if these objectives change
- The key functions of risk, actuarial, internal audit and compliance are established and are operationally independent (with the exception of internal audit which must be fully independent)
- The scope and frequency of internal reviews of the System of Governance are established, with the scope, findings and conclusions of the

reviews documented and reported to the AMSB
- The firm has contingency plans addressing areas where it considers itself to be vulnerable which are reviewed, updated and tested on a regular basis

The guidelines further specify that significant decisions that could or will have a material impact on the firm must be made by at least two persons who effectively run the firm, and that any decisions made by the AMSB are documented. Policies must also be documented to establish their purpose, the process by which they are applied, the accountability for processes and reporting, and the obligation for the organisation to inform the key functions of relevant facts.

Fit and Proper (Guidelines 11 -14)

NCAs should ensure that individuals who hold the key functions (including those who are members of the AMSB) are individually skilled and capable of undertaking the duties allocated to them and collectively provide appropriate cover for the skills required to run an insurance company. Such individuals should also be assessed for integrity, honesty and financial soundness.

Risk Management (Guidelines 15 -24)

The guidelines specify that NCAs should ensure that the AMSB is responsible for the effectiveness of the risk management system, setting risk appetite and risk tolerance limits, and approving the risk management strategies and policies. The guidelines set out the requirements for these elements of the risk management system, including the items to be covered in a risk management policy, and the need for the risk management function to report information to the AMSB, both on risks that have been identified as potentially material and on other specific areas of risk either on its own initiative or as requested by the AMSB. Particular features of underwriting and reserving risk, operational risk, asset-liability management, investment risk and liquidity risk are highlighted, as are the requirements for maintaining a policy for risk mitigation techniques.

The accompanying explanatory text expands on these guidelines, requiring firms to consider explicitly strategic and reputational risks as part of their risk management procedures, including the "interconnectedness between these risks and other material risks", highlighting the potential impact these risks may have on the business. These risks should be included in the risk management policy where relevant.

Prudent Person (Investment Management) (Guidelines 25 -30)

Under the proposed guidelines, NCAs are expected to ensure that firms take into account the prudent person principle throughout the preparatory period, "on top of the system of regulatory quantitative limits" applicable under the current Solvency I regime.

As such, NCAs should ensure that firms have developed tailored key risk indicators for investment risk and business strategy. This will include having appropriate due diligence processes around investment risk and having regard to the risk features of investments rather than relying solely on the related capital requirements.

The proposed guidelines also set out details of the minimum assessments that should be performed by firms prior to any non-routine investment decisions, management of unit-linked and index-linked contracts, unlisted investments, derivatives, and securitised instruments.

Own Funds Requirements (Guidelines 31-32)

The proposed guidelines require NCAs to ensure that firms are developing a capital management policy which includes procedures to ensure the Own Funds items satisfy (at issue and subsequently) the applicable capital regime. The policy should include controls on issuance and set out the approach to managing dividends and distributions.

The development of a medium-term capital management plan is also in the scope of the guidelines. The plan should include consideration of the output from both the risk management systems and the forward looking assessment of the undertaking's own risks (based on the ORSA principles).

Internal Controls (Guidelines 33-34)

NCAs should ensure that firms are promoting internal controls by making all personnel aware of their roles in the internal control system and ensure that there is an appropriate reporting process within this system to support decision making. Where applicable, NCAs should ensure the internal control systems are applied consistently across groups.

Internal Audit Function (Guidelines 35-39)

Guideline 35 requires NCAs to ensure that the Internal Audit Function is independent when undertaking its reviews. Subsequent guidelines cover the development of an internal audit policy addressing the scope of the work undertaken by the function, the processes to be followed before reporting to a regulator and the continuing objectivity of the internal audit staff by job rotation.

NCAs are required to ensure that an internal audit plan has been established, implemented and maintained by firms, reflecting a risk-based approach to priorities, and setting out work to be done in coming years. The function should develop processes to report its findings and recommendations to the AMSB and to follow up on these in an appropriate fashion.

Actuarial Function (Guidelines 40-47)

The proposed guidelines require NCAs to ensure that that the Actuarial Function "identifies any inconsistency with the requirements set out in Articles 76 to 85 of Solvency II for the calculation of technical provisions and implements corrections as appropriate".

Guidelines require that the Actuarial Function provides for the key risk drivers to be reflected and appropriately addressed in the valuation models as well as in the assumptions and methodologies applied. The models should be sensitive to small variations in assumptions.

The guidelines require that the Actuarial Function assesses data quality and, if relevant, recommends changes in procedures to improve data quality prior to Solvency II being introduced. NCAs should ensure changes in assumptions or methods between valuation dates can be explained by the actuarial function.

Guidelines require NCAs to ensure that assumptions are tested against experience and any deviations understood and, where material, reported to the AMSB. The inter-relationship between underwriting policy, reinsurance arrangements and technical provisions should be appropriately considered.

Where a firm is in the pre-application process for an internal model, its Actuarial Function should contribute to the specification of the risks covered by the model. This should include risks related to the terms upon which business is written. The opinion of the Actuarial Function is to be based on "a technical analysis and should reflect the experience and expertise of the function".

The Actuarial Function should report at least annually to the AMSB to document all tasks undertaken and their results, identify deficiencies and recommend how these may be resolved.

NCAs should ensure that undertakings address the potential conflicts of interest that may arise if the Actuarial Function is given additional responsibilities. The Actuarial Function for a group should provide an opinion on the reinsurance policy for the group as a whole.

We note that the proposed guidelines for NCAs in relating to the Actuarial Function have a quite different feel to other guidelines and appear significantly more "intrusive".

In particular, requirements such as those set out in guideline 41, for the Actuarial Function to identify "any inconsistency with the requirements set out in Articles 76 to 85 of Solvency II for the calculation of technical provisions", appear biased towards explaining issues of non-compliance. This in contrast to the requirements to demonstrate compliance as set out in the guidelines for the other key functions.

Furthermore, the provision set out in guideline 46, that the opinion of the Actuarial Function on the risks captured by the internal model should "reflect the experience and expertise of the function" appears to permit firms to only challenge the internal model up to the expertise of the function. While it is unclear whether this is the intention of the guideline, this appears to be inconsistent with other requirements which oblige firms to ensure the role is filled by someone of appropriate experience and knowledge.

Outsourcing (Guidelines 48-51)

In relation to outsourcing, the proposed guidelines require NCAs to ensure that firms determine whether outsourcing arrangements represent critical or important functions on the basis that the firm would be unable to deliver services to policyholders without the outsourced function. The guidelines draw specific attention to underwriting services provided by insurance intermediaries and to intra-group arrangements. The guidelines will also require firms that use outsourcing to have a policy in place to manage the arrangement throughout its term and include exit strategies.

Group Governance Specific Guidelines (Guidelines 52-57)

The last set of proposed guidelines requires NCAs to ensure groups have appropriate governance arrangements in place to steer risk management and internal control at an individual level. This should have regard to the reporting requirements, and the tools and processes needed to identify, measure, monitor and control risks, taking into account the interests of all entities and how these contribute to the common purpose of the group.

The guidelines address the group-specific challenges of contagion risk, interdependencies between risks from conducting business through different entities and in different jurisdictions, third country entities and from regulated and unregulated companies.

Further guidelines extend the scope of risk management and internal model specification to a group context.

THRESHOLDS

NCAs will be required to have measures in place from 1 January 2014 to implement the proposed guidelines in a fashion which recognises the scale and complexity of the firms to which they apply. However, unlike the proposals for the forward looking assessment and for the provision of information, no specific thresholds are proposed in respect of the System of Governance guidelines. EIOPA notes that these requirements will also be subject to “phasing-in”, such that different expectations would be placed on the assessment produced in 2015 relative to that produced in 2014.

SUMMARY

EIOPA’s publication of a consultation paper on proposed guidelines for the early introduction of the System of Governance is intended to ensure a consistent and convergent approach in preparations for Solvency II.

The guidelines are largely consistent with those set out in the Level 3 pre-consultation paper issued in December 2011 and as such, firms already engaged in the Solvency II process should find few surprises.

Despite this, we note that the proposed guidelines for NCAs in relating to the Actuarial Function appear to require the function to focus on areas of non-compliance rather than evidencing compliance. Furthermore, the rationale for basing the actuarial opinion on the internal model on the level of experience and expertise of the Actuarial Function is unclear given the fit and proper requirements which should ensure a suitable candidate fulfils this role.

ABOUT MILLIMAN

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in healthcare, property & casualty insurance, life insurance and financial services, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe. For further information, visit milliman.com.

MILLIMAN IN EUROPE

Milliman maintains a strong and growing presence in Europe with 250 professional consultants serving clients from offices in Amsterdam, Brussels, Bucharest, Dublin, Dusseldorf, London, Madrid, Milan, Munich, Paris, Warsaw, and Zurich.

www.milliman.co.uk

CONTACT

If you have any questions or comments on this briefing paper or any other aspect of Solvency II, please contact any of the consultants below or your usual Milliman consultant.

William Coatesworth
william.coatesworth@milliman.com
+44 20 7847 1655

John McKenzie
John.mckenzie@milliman.com
+44 20 7847 1531