

Increased
Corporate
Governance
Requirements
for Insurers

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INCREASED CORPORATE GOVERNANCE REQUIREMENTS FOR INSURERS

Introduction

On 17 December 2009, the definitive text of the Solvency II Directive (2009/138/EC) (“Solvency II”) was published in the Official Journal, having been signed by both the Council of the European Union and the European Parliament on 25 November 2009. Solvency II is to be implemented by Member States by 31 October 2012, although the European Commission is considering postponing the implementation date to 1 January 2013 in order to better reflect the year end dates of the majority of insurance undertakings and to enable a smoother transition from the old to the new regime.

The main objective of Solvency II is to protect the interests of policyholders and of beneficiaries by ensuring the financial stability of insurance and reinsurance undertakings within the European Union, particularly through the imposition of new solvency and governance requirements.

Solvency II is built on a three pillar structure which looks to ensure not only adequate financial resources (Pillar 1), but also effective governance by undertakings (Pillar 2) as well as increased market discipline through disclosure requirements (Pillar 3).

The purpose of this paper is to explore the impact of Pillar 2 on insurers and reinsurers. In summary Pillar 2 covers corporate governance, the principles for internal control and risk management, the requirement to prepare an Own Risk and Solvency Assessment (“ORSA”) and capital add-ons.

This paper also explores the impact of the Irish Financial Regulator’s recent Consultation Paper 41 on Corporate Governance Requirements for Credit Institutions and Insurance Undertakings (“CP41”), published on 27 April 2010. CP41 sets out the minimum requirements as to how credit institutions and insurance undertakings (life and non-life) should organise the governance of their institutions including membership of the board of directors, the role of the chairman and the operation of various board committees.

Pillar 2

We have considered the impact of Pillar 2 under the following headings below:

- ▣ System of Governance;
- ▣ Own Risk and Solvency Assessment;
- ▣ Oversight and Control Functions;
- ▣ Outsourcing; and
- ▣ Supervisory Review Process.

System of Governance

Article 41 of Solvency II requires that insurance undertakings have in place an effective system of governance to ensure the sound and prudent management of the business proportionate to the nature, scale and complexity of the undertaking's operations and it must be subject to regular review.

(i) *Governance System*

The governance system required under Solvency II must include:

- ▣ an adequate and transparent organisational structure with clear allocation and segregation of responsibilities and an effective system for ensuring the transmission of information, which must be subject to a regular internal review.

In other words, the insurer's board will be expected to demonstrate that it has clearly delegated authority through the organisation (clear written procedures showing source of authority, extent of delegation and limitations will be required) and that there is robust management information systems in place to support the delegation of authority; and

- ▣ written and implemented policies for, at a minimum, risk management, internal control, internal audit and outsourcing.

These policies must be reviewed at least annually, or more often if there is a material change, and the written policies and procedures will be subject to prior approval of the Financial Regulator under Article 41(3).

(ii) *Fitness and Probity Regime*

Persons who effectively run insurers and who are involved in key functions must, under Articles 42 and 43 of Solvency II, be fit and proper and be of good repute. The Financial Regulator introduced its Fitness and Probity regime in 2007 requiring Individual Questionnaires to be completed and submitted to the Financial Regulator for all directors and for all managers who report directly to the board or to the chief executive as part of the Financial Regulator's due diligence process.

The Financial Regulator also requires certain other office holders (for example, Compliance Officers, Money Laundering Reporting Officers (MLRO), Risk Managers and Heads of Internal Audit) to meet Fitness and Probity requirements and may request an Individual Questionnaire to be completed by these position holders. In light of Solvency II, the Financial Regulator may well decide to make this a mandatory requirement.

(iii) *Effective Risk Management*

The focus of Pillar 2 (governance) is on qualitative requirements which are seen as essential to complement the quantitative requirements under Pillar 1 (adequacy of financial resources). The foundation of Pillar 2 is the requirement for insurance undertakings to have in place sound and effective strategies and processes to assess risks to which they are exposed and to calculate the appropriate capital against these risks and to report these accordingly.

Article 44 of Solvency II requires insurers to have an effective risk management system in place which must be well integrated into the organisational structure and decision making process of the undertaking and, at a minimum, cover:

- ▣ Asset-liability management;
- ▣ Underwriting and reserving;
- ▣ Operational risk management;
- ▣ Liquidity and concentration risk management;
- ▣ Investment commitments, in particular derivatives; and
- ▣ Reinsurance and other risk mitigation techniques.

The risk management system must cover the risks included in the calculation of the undertaking's Solvency Capital Requirement ("SCR") under Article 101(4) as well as other risks which are not/not fully included in that calculation.

If a partial or full internal model is used to calculate the SCR (instead of the standard calculation), then the undertaking will need to demonstrate that the internal model is embedded in the risk management system.

The risk management system in relation to the internal model will need to cover:

- ▣ Design and implementation;
- ▣ Testing and validation;
- ▣ Documentation of the internal model and any subsequent changes to it;
- ▣ Analysis and reporting on its performance; and
- ▣ Model improvement and enhancement.

To adequately meet these requirements, undertakings should consider adopting an Enterprise Risk Management Framework which takes a risk based approach to managing the undertaking and integrates concepts of internal control and strategic planning and which addresses the needs of various stakeholders who want to understand the broad spectrum of risks facing the undertaking to ensure they are appropriately managed. An example of such a framework is the ERM Framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In addition, the undertaking should look at appointing a chief risk officer or the establishment of an executive level risk committee, or both.

The principle of proportionality can be taken into consideration when determining whether a full time chief risk officer is necessary for the risk management function. However, the insurer must be able to demonstrate that the function is objective and independent. It is possible to outsource the risk management function but in practice this is likely to be acceptable only for smaller insurers.

Own Risk and Solvency Assessment

Insurers will be required under Article 45 of Solvency II to perform an annual Own Risk and Solvency Assessment (“ORSA”) based on the risk profile, risk appetite and business strategy of the undertaking.

The assessment should highlight areas where the risk profile of the undertaking deviates significantly from the assumptions underlying the Solvency Capital Requirement (“SCR”) calculation.

The SCR is required to reflect all quantifiable risks that the undertaking might face such as underwriting risk, market risk, credit risk and operational risk and can be calculated using either a standard formula or an internal or partial internal model.

The ORSA, on the other hand, is the undertaking's economic view of capital required to run its business, irrespective of the solvency requirements set out by the Financial Regulator. The results of the ORSA may differ from the SCR due to different confidence levels, timelines and the inclusion of additional risks in the ORSA such as reputation, strategy and liquidity risk.

The ORSA is meant to provide a forward looking perspective and must be taken into account on an ongoing basis in the strategic decisions of the undertaking.

Both the results of the SCR and the ORSA must be submitted to the Financial Regulator.

Oversight and Control Functions

Solvency II also requires (Article 46) insurers to have an effective internal control system which includes at least:

- ▣ administration and accounting procedures;
- ▣ an internal control framework;
- ▣ appropriate reporting arrangements at all levels; and
- ▣ a compliance function.

(i) *Compliance Function*

The insurer's compliance function is required to assess the impact of any compliance risk that arises due to changes in the legal environment which impacts on the operations of the undertaking and must confirm to the Financial Regulator whether the undertaking is in compliance with the laws, regulations and administrative provisions adopted pursuant to Solvency II.

(ii) *Internal Audit Function*

Insurers are also required (Article 47) to have an effective and independent internal audit function in place which must evaluate the adequacy and effectiveness of the internal control system and other elements of the system of governance. Internal audit reports will be required to be filed with the Financial Regulator which will follow up with the undertaking to ensure any corrective actions agreed have been carried out.

(iii) *Actuarial Function*

Insurers are also required (Article 48) to establish an effective actuarial function to:

- ▣ ensure a robust calculation of technical provisions including a review of the appropriateness of the methodologies and underlying models and assumptions used in calculating the provisions;
- ▣ assess the sufficiency and quality of the data used in the calculation of the technical provisions and inform the Financial Regulator of the reliability of the calculation of the technical provisions;
- ▣ provide an opinion on the overall underwriting policy and adequacy of reinsurance arrangements; and
- ▣ contribute to the implementation of the risk management system in particular the risk modelling underlying the SCR calculation and the ORSA.

Outsourcing

Solvency II permits the outsourcing of critical or important functions such as the actuarial function or the internal audit function. However, undertakings will remain fully responsible for any outsourced activities.

Undertakings will be required to notify the Financial Regulator prior to outsourcing any critical or important functions as well as any subsequent material developments with respect to the functions or activities. One example of a material development would be a change in ownership of the entity to which the function has been outsourced.

In practice, insurers will need to regularly review and monitor the outsourcing arrangements they have in place to establish how they are actually working in practice. This review will need to be documented to a standard that will satisfy the Financial Regulator (as well as the insurer's board).

Supervisory Review Process

Both the qualitative and quantitative compliance of the undertaking in relation to its operating environment and current and potential risks are to be regularly reviewed and evaluated by the Financial Regulator.

The review will consider the:

- ▣ System of governance and risk assessment;
- ▣ Technical provisions;
- ▣ Capital requirements;
- ▣ Investment rules;
- ▣ Quality and quantity of own funds; and
- ▣ Use of full or partial internal model.

Following a review, the Financial Regulator can require an undertaking to remedy any weaknesses or deficiencies.

In exceptional circumstances, a capital add-on can be imposed under Article 37 particularly if the undertaking deviates significantly from the assumptions underlying the solvency capital calculation or where there are concerns regarding the governance standards within the undertaking.

Financial Regulator's Consultation Paper CP 41 - Corporate Governance Requirements for Credit Institutions and Insurance Undertakings

CP41 proposes an enhanced corporate governance regime for credit institutions and insurance undertakings which together with more demanding regulatory requirements and intrusive supervision, is intended to create a financial sector which is stronger and more resilient to any future stresses.

This Consultation Paper is part of a wider plan by the Financial Regulator to update the domestic regulatory framework applicable to credit institutions and to insurance undertakings and it is expected that the Financial Regulator will issue further requirements in due course, including requirements as to remuneration and a revised fitness and probity framework.

CP 41 proposes that the requirements will apply to all credit institutions and to insurers licensed by the Financial Regulator, including Irish licensed and authorised subsidiaries of international financial services groups. The proposed new requirements will not apply to foreign incorporated subsidiaries of an Irish entity. However those institutions are encouraged to adopt equivalent good corporate governance practices in their foreign incorporated subsidiaries.

Corporate governance is described in the Consultation Paper as a reference to the "*procedures and processes according to which an organisation is directed and controlled*". The Financial Regulator points to some of the outcomes of the financial crisis as highlighting the importance of aligning good corporate governance with good regulation. The requirements proposed in CP41 are also stated to be in addition to, and not instead of, any other applicable corporate governance obligations and standards to which an institution is subject.

The Financial Regulator's proposals as set out in CP41 include:

- ▣ imposing requirements in terms of the minimum number of directors on the board;
- ▣ limiting the number of directorships which directors may hold so as to ensure they can comply with the expected demands of board membership of an institution;
- ▣ requiring that board membership is reviewed at a minimum every 3 years;
- ▣ requiring clear separation of the roles of Chairman and CEO and precluding an individual who has been CEO, director or senior manager during the previous five years from becoming Chairman of that institution;
- ▣ setting out clearly the role of the independent non-executive directors;
- ▣ requiring the board to set the risk appetite for the institution and to monitor adherence to this on an ongoing basis;
- ▣ setting out the minimum requirements for board committees; and
- ▣ requiring annual confirmation of compliance to the Financial Regulator.

The proposed limit on the number of directorships which a person may hold and the prohibition on certain categories of persons from acting as independent non-executive directors of a company with which they have been associated in the past may have far reaching consequences and require changes to the boards of credit institutions and of insurance undertakings.

Upon finalisation of the Consultation Paper, the Financial Regulator has proposed a six-month lead in time to adopt and comply with the new requirements. Where the requirements necessitate changes to board membership the transition period will be extended to 12 months to allow institutions time to identify and assess candidates prior to making new appointments.

In practical terms, this means that insurers will need to review their corporate governance procedures and ensure they have arrangements in place which deal with matters such as board composition, clear segregation between the roles of Chairman and CEO, the role of the board, provisions for the assessment of the independence and the appointment of non-executive directors including developing appropriate terms of reference for them and appoint appropriate committees with responsibility for areas such as audit, risk, remuneration and nominations. There are very specific requirements in the draft Consultation Paper dealing with these and many other aspects of the day to day management and control of the institutions as defined in the Consultation Paper, however it is not possible to deal with each of them in detail in this article.

The Consultation Paper itself is drafted in imperative terms and uses the word "shall" throughout which means that relevant companies will not have any discretion in terms of

deciding whether or not to comply with the new provisions, they will have to comply regardless.

However, the Consultation Paper, while stating that its provisions apply to all insurers, recognises nonetheless the differences in the nature of the business and risk characteristics of different institutions and, while the new provisions will still apply to them, they may be applied proportionately. In addition, in the same spirit of proportionality, the Financial Regulator is of a mind not to apply the full requirements in the Consultation Paper to captive insurers and has invited submissions from the captive insurance industry in this regard.

The section dealing with “General Requirements” permits the governance structure put in place by each institution to have regard to the nature scale and complexity of the activities of the institution in deciding the extent of the new measures required to be adopted by them.

It is also worth noting the Financial Regulator’s intention to take a more pro active role in the supervision of the relevant companies. In that regard, the Consultation Paper also includes a requirement for companies to submit an annual, or more frequently if required, compliance statement to the Financial Regulator specifying whether the company has complied with the proposed new requirements in the period to which the statement relates.

Failure to comply with the proposed new requirements will be an offence and be subject to administrative sanctions under the Financial Regulator’s Administrative Sanctions regime. Potential penalties under the Administrative Sanctions regime range from caution or reprimand to the disqualification of directors and monetary penalties (not exceeding €5,000,000 in the case of a corporate and unincorporated body, and not exceeding €500,000 in the case of a person).

The Financial Regulator intends to consult with the Consultative Industry and Consumer Panels as part of the Consultation Process. The closing date for submissions is 30 June 2010.

Conclusion

Both the global and domestic economic crises have highlighted the need for corporate governance practices to be re-examined and strengthened so as to restore confidence in the financial services sector and to improve the long term sustainability of financial services firms including insurance undertakings.

While insurance undertakings may have relied too heavily on quantitative models and external ratings and benchmarks in the past, the implementation of Solvency II recognizes that such quantitative measures need to be supported by qualitative measures to bring about long term stability in the insurance sector. The qualitative measures outlined in Pillar 2

should help ensure that insurance undertakings have appropriate risk management and oversight systems in place to support capital adequacy. The emphasis is on sound and prudent management with clear lines of responsibility, robust management information and effective oversight functions to feedback to the board where adjustments are required.

With the transposition of Solvency II, the Financial Regulator will have increased supervisory responsibilities including sign off of key policies and procedures of insurance undertakings and additional oversight powers to test compliance with quantitative and qualitative aspects of solvency requirements.

In terms of corporate governance requirements and in light of the recent financial crisis the Financial Regulator has set out in CP 41 the measures it expects insurance undertakings to take to achieve an appropriate level of corporate governance.

While there is an acknowledgement of proportionality when implementing these measures, there is, nevertheless, a very clear emphasis on the need for good corporate governance aligned with robust regulation to secure the long term interests of the insurance sector and to protect the interests of policyholders, beneficiaries and shareholders.

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