

Response to IAIS draft application paper on supervision of control functions

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Q1. General comments on the draft application paper

Insurance Europe supports a principle-based approach to the organisational structures of control functions, with a clear allocation of responsibilities. It is key that:

- Control functions are set up in a way that is appropriate and adequate to accomplish the tasks assigned to them.
- Supervisors' focus is risk-based and proportionate to the characteristics of each insurer. And their primary focus are on outcomes, rather than individual elements.

Furthermore, the paper puts an overly strong and siloed emphasis on concepts, such as independence, the precise positioning of control functions in organisational structures and a rigid application of models, such as the three lines model.

The paper can be improved by focussing clearly on the role of control functions in managing risks. It puts too strong an emphasis on how the design of a corporate governance framework can help insurers to avoid risks, even though it states in the first sentence that "effective control functions [...] help insurers identify and manage risks".

The paper focuses very much on the separation of responsibilities and does not recognise an essential element of the three lines model; namely that first and second line roles may be blended or separated¹. Specifically,

- Some second line roles may be assigned to specialists to provide complementary expertise, support, monitoring and challenge to those with first line roles.
- Second line roles can focus on specific objectives of risk management, such as: compliance with laws, regulations and acceptable ethical behaviour; internal control; information and technology security; sustainability; and quality assurance.

¹ As stated in principle 3 of the updated three lines model (<https://global.theiia.org/about/about-internal-auditing/Public%20Documents/Three-Lines-Model-Updated.pdf>)

- Second line roles may span a broader responsibility for risk management, such as enterprise risk management (ERM).

Insurance Europe recognises that the governing body, management and internal audit have their distinct responsibilities, but it highlights that all activities need to be aligned with the objectives of the organisation. And to this end, regular and effective coordination, collaboration and communication are essential.

The paper should explicitly refer to the evolved three lines model, as updated recently by the Institute of Internal Auditors. As such, and the paper should put clearer focus on the contribution that risk management makes to achieving objectives and creating value. Instead of solely focusing on “defence”, potentially leading to siloed and ineffective and inefficient internal control systems, the paper should give attention to both matters of defence and protecting value

The paper should also state more prominently the importance of the national supervisory authorities recognising the fact that every insurer is different both in terms of business profile (eg size, risk profile, business models) and resources/capacity. While Insurance Europe recognises the non-binding nature of the application paper, it warns of the risk that the extensive description in the examples leads supervisors to seek a unified approach to corporate governance frameworks. Against this background, it is important for the effective implementation of the ICPs that national supervisory authorities consult and thoroughly discuss these with the insurers in their jurisdictions.

Q7. Comment on Paragraph 5

Insurance Europe welcomes the fact that the paper has a number of references to the principle of proportionality, which enables the ICPs to be implemented and applied in a reasonable manner, taking account of the specific characteristics of individual insurers’ business. The paper would benefit from further analysis of how proportionality could be applied effectively in practice.

Q8. Comment on Paragraph 6

Insurance Europe agrees that risk-based supervision is an important concept. The paper would benefit from further analysis of how this could be applied.

Q10. General comments on Section 2: Role of control functions

Insurance Europe suggests introducing examples of proportionality for small businesses, especially in relation to the combination of key functions.

Q16. Comment on Paragraph 13

The second sentence gives the false impression that unseparated lines of defence will not be able to fulfil their function, which goes beyond what ICP 8 and standard 8.3 provide. Indeed, ICP guidance 8.3.10 explicitly mentions the possibility of insurers combining certain control functions. Insurance Europe suggests adding “better” immediately after “helps” to read: “the clear separation of responsibility helps better avoid or mitigate bias, conflicts of interest or undue influence of one function on professional or business judgments of another function.”

Q19. Comment on Paragraph 16

Insurance Europe suggests that the paragraph clarifies that supervisors should focus on the outsourcing of essential or critical activity or functions.

Q23. General comments on Section 3: Independence of control functions

Independence is, indeed, an important element and is in fact recognised in ICP 8.3. However, the strong focus on independence in this section is not helpful. Independence is not a goal in itself, but should contribute to a well-functioning, outcome-based control function. Well-structured and positioned control functions, with a clear allocation of responsibilities, authority and transparent reporting lines, contribute to their proper functioning, with a sufficient level of independence.

Q26. Comment on Paragraph 22

On the third bullet point on remuneration, Insurance Europe suggests specifying that staff refers to “senior” staff.

On the fourth bullet point on internal staff moves, the reference to time-limit restrictions should be deleted. While the identification and mitigation of potential conflicts of interest is important, a time restriction is not always an effective measure. Time restrictions have the downside of blocking the position shift, completely compromising the proper functioning of the control function at issue, while a conflict of interest might be mitigated by a more tailored solution (eg, phase-in of the control in the unit in which the person was previously engaged, etc.)

Q29. Comment on Paragraph 25

With regard to the last bullet point, the dominant personality is a subjective concept on which to base a governance framework or supervisory practice. It can be perceived differently by different people, etc. What matters is the fitness and propriety of the Key Function Holders, not the personality of their counterparts.

Q35. Comment on Paragraph 31

This paragraph seems to imply there could be a conflict of interest when certain control functions are combined in senior management functions, which contradicts the good practice in place in insurance undertakings. There are cases where control functions such as the risk control function are part of senior management or even of the board itself (eg, chief risk officer). Control functions should be implemented at a higher hierarchical level to ensure independence, positioning, direct reporting lines to the management board and all the other conditions mentioned in the paper under section 3. This paragraph should recognise that a conflict can only arise when a control function is combined with certain functions (eg, risk-taking function).

Q36. Comment on Paragraph 32

General comment on section 3.2: Insurance Europe welcomes every reference to help apply proportionality to remuneration.

Q37. Comment on Paragraph 33

The proportions of the remuneration should not be given a particular stress when assessing the effectiveness of the remuneration package. This contradicts with ICP guidance 7.6.10 which has another bullet point which explicitly recognises the possibility that the variable component can be a significant part of an effective remuneration package. What needs to be assessed by supervisors is whether there are appropriate checks and balances. It also notes that fixed remuneration can be less of a long-term incentive than variable remuneration, in particular if the latter is subject to deferral and downward adjustments.

Q40. Comment on Paragraph 35

The paper should recognise the ability of control functions to cooperate with the other functions and business units as another element supporting the stature, in addition to the ability to operate independently in a silo.

Q41. Comment on Paragraph 36

The last point should be deleted. Positive findings are not an appropriate indicator of the ability of control functions to ensure a good level of independence.

Q42. Comment on Paragraph 37

Insurance Europe suggests replacing the word "evidence", which appears to be excessive, with the word "information".

Q49. Comment on Paragraph 44

Insurance Europe would highlight that staffing is highly dependent on the size of the undertaking. ICP standard 7.3 recognises that the appropriate number of staff can differ between insurers.

Q52. Comment on Paragraph 47

Insurance Europe would disagree with the prominent status given to analyses of meeting minutes, which is cited first as a means of assessing the ability of the key persons in control functions to challenge.

Meeting minutes, particularly minutes of a board meeting, are not prepared for supervisors but for corporate record-keeping. It is up to insurers to decide how they prepare minutes, taking into account corporate law requirements. Meeting minutes may be elaborate (even verbatim) or more or less concise, depending on jurisdiction, culture, and corporate law requirements. The absence of references in board minutes to control functions might not give any indication of actual involvement. The risk exists that supervisors will draw inappropriate conclusions from the manner minutes are prepared, rather from the actual lack of involvement of control functions.

Q59. Comment on Paragraph 54

This paragraph on the supervisor's attendance at board meetings should be deleted. Its benefit is not sufficiently justified.

Q75. Comment on Paragraph 68

Insurance Europe appreciates the fact that the paper recognises the reality of smaller insurers by taking into account the possibility to combine certain control functions.

Q80. Comment on Paragraph 73

This paragraph should also recognise the benefit of a vertical combination in facilitating harmonisation throughout a group.

Q81. Comment on Paragraph 74

Insurance Europe appreciates the fact that the paper recognises the reality of smaller insurers by taking into account the possibility to combine certain control functions.

However, it appears that "operational function" is not defined either in the ICPs or the paper. The IAIS should clarify the operational function's boundaries to help avoid any problematic interpretations.

Q85. Comment on Paragraph 78

This paragraph seems to imply that being a key person in a control function while simultaneously holding a senior management position creates a conflict of interest. In Insurance Europe's view, an observed good practice is to implement control functions at a higher hierarchical level to ensure effectiveness. This paragraph should recognise that a conflict can only arise when a person holds the senior management position in addition to certain control functions (eg, the risk-taking function).

Q92. Comment on Paragraph 84

Regarding outsourcing, Insurance Europe suggests that the paragraph clarifies that supervisors should focus on outsourcing of essential or critical activities or functions.

Q94. Comment on Paragraph 85

The paper should appropriately highlight the importance of the group entity's discretion over the design of its own system of governance. The head of the group should not impair the responsibilities of the board of each entity in the group when setting up their own system of governance.

Q95. Comment on Paragraph 86

Insurance Europe suggests modifying the fourth bullet point in this paragraph to acknowledge that there are cases in which group-wide harmonisation is not appropriate. Companies should be able to have the most appropriate policies for the respective levels within the group. Group-wide harmonisation of methods, for example, can jeopardise the independence of the control functions at the individual legal entity level. In addition, the size, risk profile and business model of the individual entities are different, so harmonisation would not be in line with the principle of proportionality. Insurance Europe would suggest making the following changes:

*"Reviewing the documented roles and responsibilities of the group-wide control functions, including how the group-wide and insurance legal entities' control functions are meant to interact, how the group-wide control functions, in their own fields, ensure the harmonisation of the group's methods, **as far as is possible and permissible taking into account the differences in size, risk profile, business model and legal framework of the individual legal insurance entities**, and assess the proper implementation of policies defined at group level, and compare them with observed practices. If inadequate, requiring more comprehensive policies;"*

Q96. Comment on Paragraph 87

Paragraph 87 and the following paragraphs should recognise the possibility for, in particular, international groups to apply group-wide policies on a comply-or-explain basis, meaning that a single entity can choose not to comply with the group policies but should explain why.

Q101. Comment on Paragraph 92

The general statement that a combination of control function at group level and at solo level could create conflicts of interest should be removed. The paper does not specify what conflict of interest may arise in such cases. On the contrary, such a combination can facilitate harmonisation throughout a group, which paragraph 86 advises.

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — it represents all types and sizes of insurance and reinsurance undertakings. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers pay out almost €1 000bn annually — or €2.7bn a day — in claims, directly employ nearly 950 000 people and invest over €10.4trn in the economy.