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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS

OECD guidelines for insurers’ governance

RECOMMENDATION OF THE COUNCIL

These guidelines, prepared by the OECD Insurance and Private Pensions Committee, were adopted by the OECD Council on 28 April 2005.

1. The OECD Ministers agreed in 2002 "that implementation of best practices in corporate and financial governance entails an appropriate mix of incentives, balanced between government regulation and self-regulation. [They] seek to improve such governance to enhance transparency and accountability and thereby strengthen investor confidence and the stability and resilience of financial markets".

2. The emphasis on financial governance as well as broader corporate governance reflects both the essential role of financial markets in the economy and the distinct risks and responsibilities of the sector. The emphasis on governance is because, even in highly regulated sectors, regulation alone cannot achieve the good practice necessary for integrity and effectiveness. Companies themselves must develop internal rules and systems in order to reach these goals, but governments and international bodies can provide guidance on these rules and systems.

3. When discussing its 2003-2004 programme of work, the Insurance Committee agreed to take up the challenge to produce Guidelines for Insurers' Governance. This work was intended to capture the specificities of the governance of insurers and to complement the revised OECD Principles of Corporate Governance[1].

4. The governance of insurers must address sector-specific issues related, for instance to the responsibilities of fiduciaries, the rights of beneficiaries/ policyholders, or the non-corporate (e.g. mutual insurers) nature of some insurers. In addition, all insurance entities are exposed to various technical (e.g. actuarial, underwriting and investment risks) and non-technical risks. The insurance business is also characterised by complex principal-agent relationships, as well as asymmetry in market power and information among various stakeholders. Some agency problems are common to all insurance entities, while others arise in the context of particular sub-sectors, namely life insurance, non-life insurance and reinsurance.

5. Various aspects of the legal and regulatory infrastructure for insurance in OECD countries address these risks. For instance the underwriting of insurance risks is restricted to licensed insurance entities. Prudential regulation and supervision, solvency requirements and external oversight enhance the protection of policyholders against conflicts of interests and cover default risks.

6. In view of this extensive regulation and oversight of the insurance sector, the Insurance Committee and its Working Party on Private Pensions pursued two main objectives in drafting the Guidelines:

to provide complementary guidance that would help the sector to enhance the protection of policyholders and/or shareholders beyond the protection already provided by existing regulation and supervision; and

to develop complementary guidance specifically directed to the insurance sector that would supplement corporate governance rules generally applicable to corporations.

7. In this perspective, the Guidelines offer direction, but do not constitute either a binding code or a standard. Besides, the Guidelines are sufficiently flexible to take into account the specific agency conflicts that are common to the sector, the unique characteristics of each branch of activity, and the existence of various forms of ownership. Specific guidelines are provided for mutual insurers in view of their non-corporate nature. The Guidelines also highlight the particular importance of the actuarial function in the governance structure of insurers.

[1] See OECD website, http://www.oecd.org/daf/corporate/principles.

8. The Guidelines are directed to the insurance community, including stock companies, mutual insurers or any other kind of ownership, insurers and reinsurers. They draw on the experience of the Member countries and other organisations represented in the Committee. In particular, the Committee took careful note of and refers to the International Association of Insurance Supervisors' compilation of Insurance Core Principles on Corporate Governance that was published in January 2004, as well as other IAIS work and comments.

9. The guidelines also benefited from the work and revision of the OECD Principles of Corporate Governance, which they complement. Accordingly, the Committee has understood and used the term "governance" in the Guidelines as the term is formulated in these Principles.

10. In this respect, the Insurance Committee and the Working Party on Private Pensions also decided that the work they were developing on both the Guidelines for Insurers' Governance and the Guidelines for Pension Fund Governance needed to be conducted in close co-operation with the Steering Group in order to ensure full consistency of these Guidelines with the revised OECD Principles of Corporate Governance, and that these Guidelines should first be submitted to the Steering Group before being sent to the Council.

11. The Guidelines for Insurers Governance (which were endorsed by the Insurance Committee in September 2004) along with the new Guidelines on Pension Funds Governance, were therefore transmitted to the Steering Group subsequent to the revision of the OECD Principles of Corporate Governance. At its 19-20 October 2004 meeting, the Steering Group considered that both sets of Guidelines are fully compatible and consistent with the revised OECD Principles of Corporate Governance.

12. In addition, the Guidelines presented here have drawn from the work related to the Guidelines for Pension Funds Governance. A number of specificities of the insurance sector are comparable to those of pension funds, such as the insurer's fiduciary role vis-à-vis its policyholders, the importance of the whistle blowing functions of auditors and actuaries and the technical complexity of the products sold.

13. The document in Annex to Appendix I presents the final version of the Guidelines for Insurers' Governance as approved by the Insurance Committee and after compatibility checking by the Steering Group. The Guidelines as such are articulated around three main sections related to 1: Governance structure, 2: Internal governance mechanisms and 3: Stakeholders' protection. Each guideline is numbered and headed by a statement followed by a series of recommendations and specifications in italics. The guidelines are also complemented by annotations set out in Appendix II, providing some background information on their rationale and focusing on more specific insurance issues, i.e. actuaries and mutual insurers. Appendix II is not formally part of the draft Recommendation and as such may be amended as necessary by the Insurance Committee.

APPENDIX I

RECOMMENDATION OF THE COUNCIL ON GUIDELINES FOR INSURERS' GOVERNANCE

THE COUNCIL,

Having regard to Article 5b) of the Convention on the Organisation for Economic Cooperation and Development of 14 December 1960;

Considering that the OECD Ministers agreed in 2002 "that implementation of best practices in corporate and financial governance entails an appropriate mix of incentives, balanced between government regulation and self-regulation. [They] seek to improve such governance to enhance transparency and accountability and thereby strengthen investor confidence and the stability and resilience of financial markets";

Considering that the integrity of financial institutions depends not only on regulation and supervision, but also on the quality of governance practices within financial institutions;

Considering that the specificity of the risks and responsibilities faced by insurance providers call for specific guidance on governance in addition to the more general standards provided by the revised OECD Principles of Corporate Governance;

Considering that the Guidelines for insurers' governance (hereinafter called "the guidelines") complement the revised OECD Principles of Corporate Governance and that the Steering Group on Corporate Governance in October 2004 expressed the view that the Guidelines on Insurers Governance are fully compatible and consistent with the revised Principles;

Considering that a number of specificities of the insurance sector are comparable to those existing for pension funds, such as the insurer's fiduciary role vis-à-vis its policyholders and the technical complexity of the products;

Considering that these guidelines are meant to provide guidance to the insurance community as a whole including stock companies, mutual insurers or any other kind of ownership, insurers and reinsurers internationally- thereafter designated as "insurance entities" or "insurers";

Considering that the Insurance Committee has elaborated these Guidelines on the basis of experiences of Member countries and relevant international institutions, and organisations, in particular the International Association of Insurance Supervisors;

Recognising that evolutions in the insurance community or/and in the revised Principles of Corporate Governance may call for further updating and adaptation of these guidelines;

On the proposal of the Insurance Committee;

I. RECOMMENDS that Member countries invite public authorities and insurance entities to ensure an adequate and efficient governance framework for insurers, having regard to the contents of the Annex to this Recommendation of which it forms an integral part.

II. INVITES Member Countries to disseminate these guidelines among public and private insurers.

III. INVITES non Member Economies to take account of the terms of this Recommendation and, if appropriate, to adhere to it under conditions to be determined by the Insurance Committee.

IV. INSTRUCTS the Insurance Committee to exchange information on progress and experiences with respect to the implementation of this Recommendation, review that information and report to the Council within three years of its adoption, or sooner, and, as appropriate, thereafter.

ANNEX

GUIDELINES FOR INSURERS GOVERNANCE

The following guidelines are applicable to any insurance entities (hereinafter called either "insurer" or "insurance entity") licensed to underwrite life, non life and reinsurance policies. They are designed in light of the overriding objective of an insurance entity which is to provide benefits to the insured in accordance with the contracts concluded with them, and to satisfy its shareholders (participating policyholders in the case of mutual insurers). Having regard to the specificity of reinsurance business, some specific recommendations as regards stakeholders' protection, may not be fully applicable to reinsurers.

These guidelines are non-binding. They are only meant to provide guidance and to serve as a reference point as regard to the specificities of the governance of insurers, for the OECD and non-OECD members' policy makers and for their insurance industry as well as its main stakeholders. As such, policy-makers and market players may apply them if they consider it opportune, through diverse regulatory frameworks and according to the specificities of their jurisdiction (either through corporate law, or rules that specifically apply to the insurance industry such as Insurance Acts, and/or through codes of conduct set up by the private sector).

These guidelines are consistent and compatible with the revised OECD Principles of Corporate Governance, which they complement.

I- Governance Structure

The governance structure must establish an appropriate division of administrative and oversight responsibilities, stipulate and delineate the qualifications and duties of persons bearing responsibilities, and protect the rights of policyholders and shareholders or "participating policyholders"[2].

Guideline 1. Identification of responsibilities

Within an insurance entity, the responsibilities of every corporate body must be stipulated clearly.

Likewise, the main factors which may have a significant influence on governance should be ascertained and made public. Accordingly, the form of ownership and any provisions for changing it, the scope of business, the internal governance structures and the entity's primary objectives must be set out clearly in its statutes, by-laws or contracts or in documents associated with these.

[2] The term "participating policyholders" refers hereinafter, for instance, to the particular status of policyholders/shareholders in the case of insurers taking a mutualist or cooperative form.

Guideline 2. Board(s) structure

The structure of the governing body, whether single (board of directors) or dual (having a board of directors and a supervisory or executive board), should be defined, along with the responsibilities of each entity. These responsibilities should be consistent with the insurer's core objective of providing benefits pursuant to its contracts. The governing body is ultimately responsible and should not be allowed to completely absolve itself of its responsibilities by delegating certain functions to subcommittees or external service providers.

Accordingly, the governing body should retain the responsibility for monitoring and oversight of those service providers or subcommittees.

Guideline 3. Functions and responsibilities

The Board's main responsibilities should cover those functions essential to good governance, i.e.:

- *reviewing and guiding the strategy of the insurance entity, including reinsurance strategies, major plans of action, risk policy related to the main insurance risks and annual budgets,; approving the pricing strategy, setting performance objectives, overseeing auditing and actuarial functions, and other oversight structures and monitoring the administration of the insurance entity in order to ensure that the objectives set out in the fund by-laws, statutes or contracts, or in documents associated with any of these, are attained (e.g. diversified asset allocation, cost-effectiveness of administration, etc.);*

- *selecting on a fit and proper basis, compensating, monitoring, and where necessary replacing staff with operational responsibilities as well as external service providers which can play an important function in the management of insurers (e.g. asset managers, actuaries, auditors, etc.);*

- *monitoring and managing potential conflicts of interest between board members and shareholders, including misuse of the entity's assets and abuse in related party transactions;*

- *ensuring the compliance of the activities of the entity with the Law and in particular the Insurance Law (e.g. investment regulations, reporting and disclosure requirements, etc);*

- *monitoring the effectiveness of the governance practices under which it operates and making changes as needed.*

Guideline 4. Composition and suitability

The number of board members, how they are selected and a fair balance between executive and non-executive directors should be specified in the by-law or legal status of the entity or in documents associated with any of these.

A sufficiently high proportion of directors should be non-executive. Such requirement may be replaced by the existence of a bicameral structure or a supervisory body. In both cases, concerned members should be independent of influences that may limit their capacity to provide objective oversight of the entity. As regards to mutual insurers with a single board structure, specific control may be needed to compensate the limited control exercised by participating policyholders.

The term of office of board members and, how they are elected, should also be specified.

Board members should have the necessary qualification to act in accordance with their responsibilities and functions and to ensure a high level of integrity and professionalism in managing the insurance entity.

Members of the governing body should be subject to minimum suitability standards and possess the appropriate integrity, competence, experience and qualifications. Conviction for fraud or other economic crimes, the fact of being subject to disciplinary restrictions by a professional body, gross mismanagement of another entity that led to significant civil penalties, personal bankruptcy and the consequences of an administrative decision implying the disqualification of a member of the governing body should be considered clauses for disqualification.

Guideline 5. Accountability

Board members are accountable to the entity's shareholders and/or policyholders, or participating policyholders and/or to the competent authorities. To ensure that accountability, board members are legally liable for their actions and decisions.

The accountability of the governing body requires: regular meetings of the governing body; information on decision-making power in the governing body; appropriate disclosure of the material decision reached in these meetings which concern the relations with insured and shareholders (or participating policyholders); reporting of information about the operation of the insurance entities to the supervisory authorities; transparent selection mechanisms for the members of the governing body; appropriate succession planning processes.

The selection and succession planning structure should deal with the term, appointment/election and removal of members of the governing body of the insurance entity.

Guideline 6. Actuary

The insurer should nominate an actuary who reports to the Board and management — at least in the case of a life insurance entity, and who should be able to act in an independent way. The use of actuarial standards in non-life insurance entities should be promoted as well. This actuarial function should preferably be fulfilled by an appointed actuary. It may also be performed by any manager of the entity who should have the possibility to report directly to the Board, or by an external consultant.

The actuary's responsibilities, and any advisory role vis-à-vis the Board or the management as well as his/her rights and obligations, should be set forth clearly. As soon as the actuary realises, on performing his/her professional or legal duties, that the entity does not or is unlikely to comply with the appropriate requirements and depending on the general regulatory framework, he/she must be able to so inform the Board or the management and the External Auditors ("*whistle-blowing" function).* The Board should have access to the Actuary as well. In the use of its whistle–blowing functions the appointed actuary should be protected by the applicable insurance legislation or regulation of the jurisdiction or by the by-laws and status of the entity and if possible of the professional body.

The actuary should be subject to strict qualification and suitability standards in compliance with the supervisory framework of the concerned jurisdiction.

Guideline 7. External Auditors

An external auditor *independent* from the insurance entity, its management and its board(s) should be appointed to certify the entity's accounts on at least an annual basis. His/her term of office should be limited and renewable under specific conditions.

The auditor should be able to alert the competent authorities promptly of any event that could seriously affect the entity’s financial position or the organisation of its administration or its accounting and of any criminal violations and material irregularities, ("*whistle-blowing" function*).

The auditor should be able to make use of actuarial skills whether internally or externally. In the case where the appointment of an actuary is required by the jurisdiction, he/should be able to report to the auditor.

The auditor should be subject to strict qualification and suitability standards in compliance with the supervisory framework of the concerned jurisdiction.

II – Internal Governance Mechanisms

Insurance entities should have appropriate control, communication and incentive mechanisms that encourage good decision-making power and timely execution, transparency, disclosure and ensure regular review and assessment, having regard to the branches of business operated. These mechanisms should be tailored to the protection of policyholders, beneficiaries and shareholders (or participating policyholders).

Guideline 8. Internal controls

Appropriate controls should be put in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives for each class of business that are set out in the insurers’ by-law, statutes, contracts or in documents associated with any of these, and that they comply with the law.

Such controls should cover all basic organisational and administrative procedures, depending upon the scale and complexity of the class of business. These controls mainly under the responsibility of the board will include performance assessment, compensation mechanisms, information systems and processes, (asset and liabilities) risk management. The board should also ensure that management takes prompt action to correct any material control problems that emerge from these reviews and that there is a board process in place to follow up on progress made to correct deficiencies. Useful inputs into these controls include management reports, internal and external audit opinions and audit reports on the financial statements, reports of the appointed actuary, and views and observations of the supervisory authorities as well as views, solicited by the board, of the entity’s external and internal auditors and legal counsel.

Guideline 9. Reporting

Reporting channels between all the persons and entities involved in the administration of the insurer should be established in order to ensure the effective and timely transmission of relevant and accurate information.

Processes need to be put in place to ensure that the members of the governing body receive appropriate, timely, accurate, complete and easily comprehensible information so they may discharge their responsibilities effectively, in accordance with the code of conduct, and ensure that the delegated responsibilities are fulfilled. For its part, the governing body should ensure that actuaries, asset managers, consultants and other professional service providers also receive relevant and accurate information in a timely manner in order to ensure they carry out their duties as established by the governing body.

III- Stakeholders' protection

The governance framework of insurance entities should ensure an appropriate protection of the rights of stakeholders through disclosure and redress mechanisms and the compliance with the basic rights of shareholders or participating policyholders in the case of mutual insurers.

In the case of entities taking a corporate form, the principles II and III in the OECD revised corporate governance principles, dedicated to the rights of shareholders and key ownership functions and the equitable treatment of shareholders should be referred to.

Guideline 10. Protection of participating policyholders in the case of mutual insurers

In the case of mutual insurers, the governance framework should also accurately protect the rights of participating policyholders, accordingly:

1. Members may: 1) waive their interests in the entity through ending their insurance contract, subject to the terms and conditions of that contract; 2) participate and vote in general meetings, whether directly or indirectly; a general meeting may also be held in the form of a meeting of members' representatives, the section assembly. If this is constituted by direct elections, all members of the entity have voting rights. Co-option through the meeting of member's representatives is allowed ; 3) obtain relevant information on the entity on a timely and regular basis; 4) elect members of the board; or in the case of a bicameral structure elect the members of the supervisory board who then appoint the members of the board; and 5) approve proposals of the board of rebates, supplementary contributions and distribution of surplus earnings.

2. Members may participate directly or through the meeting of representatives and be sufficiently informed on, decisions concerning fundamental changes to the entity, such as: 1) amendments to the statutes (demutualisation, re-organisation by creating a mutual holding entity, etc.); 2) authorisation to issue participating securities or to issue bonds or subordinated instruments if this decision implies some material impacts for members; 3) the transfer of all or part of the policy portfolio.

3. a) Where no meeting of members' representatives exists, members should have the opportunity to participate effectively and vote in general meetings and should be informed of the rules, including voting procedures, that govern general meetings:

   - *Members should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.*

   - *Opportunity may be provided for members to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.*

   - *Members may be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.*

   b) Where a supervisory body comprising member representatives exists, the role of the members within the general meetings mentioned under item a) should be transferred to the members' representatives and their general meeting.

Guideline 11. Disclosure

Insurance entities should disclose relevant information on a clear and timely basis in order to give stakeholders (including policyholders, shareholders or participating policyholders, supervisory authorities, etc.) a proper view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed. However, information on risk management procedures should be provided with due respect of data protection and confidentiality obligations and should avoid to limit the competitiveness of insurance entities.

Disclosure should include, but not be limited to, quantitative and qualitative material information on the financial and operating results of the entity; financial position; financial performance; and a description of risk exposures and how they are managed; the basis, methods and assumptions upon which information is prepared (including comments on and the impact of any changes); management and corporate governance.

In addition, information transparency towards policyholders should cover inter alia information on the products including the associated risks, benefits, obligations and charges under the contract; other matters related to the sale of insurance policies including possible conflict of interest with existing potential policyholders.

Guideline 12. Redress

Policyholders and participating policyholders should be granted access to statutory redress mechanisms through at least the regulatory/supervisory authority or the courts, which can assure prompt redress.

In addition, the setting up of alternative redress channels, such as internal dispute procedures and independent arbitrators or ombudsmen, should be encouraged. An arbitrator may be set up by the industry itself in order to encourage public confidence and maintain efficient business practice.

APPENDIX II

ANNOTATIONS
TO THE GUIDELINES ON INSURERS' GOVERNANCE

A - RATIONALE FOR THE GUIDELINES

14. Regardless of the legal or ownership structure of insurers, all insurance entities are exposed to various technical (e.g. actuarial and underwriting risks and investment risks) and non-technical risks. In addition, the insurance business is characterised by complex principal-agent relationships, as well as asymmetry in market power and information among various stakeholders. Some agency problems are common to all insurance entities, while others arise in the context of particular sub-sectors, namely life insurance, non-life insurance and reinsurance. Various aspects of the legal and regulatory infrastructure for insurance in OECD countries address these risks: For instance the underwriting of insurance risks is restricted to licensed insurance entities. Prudential regulation/supervision, solvency requirements and external oversight enhance the quality of protection for policyholders against conflicts of interests as well as cover default risks.[1] Considering this rather extensive regulation and oversight of the insurance sector, the drafting of guidelines dedicated to the governance of insurers should focus on two main issues: what complementary guidance could help this sector in enhancing the protection of policyholders and/or shareholders in addition to the protection already provided by the regulation and supervision in place and what complementary guidance specifically dedicated to the insurance sector could supplement corporate governance rules generally applicable to corporations. To these ends, the governance framework for the insurance business must be well-defined, but sufficiently flexible to take into account the specific agency conflicts that are common to the sector, the unique characteristics of each branch of activity, and the existence of various forms of ownership: stock companies, mutual structures as well as unique structures like Lloyd's.[2]

Agency conflicts within insurance entities

15. Like other categories of financial services, the insurance business is subject to potential conflicts of interest between owners and managers, but with an added potential conflict involving policyholders. The nature of the conflict varies depending on whether an entity is structured as a share company or as a mutual insurer[3]. In the case of the former, there is the potential conflict of interest arising from the separation of ownership from control. Although the particularity of the insurance business adds a layer of complexity, this conflict is similar to what arises in the non-financial sector and is not elaborated upon further herein. With a mutual insurer, the roles of policyholders and "owners" (cooperatives) are somehow combined, which should address any potential conflict between the need to build sufficient reserves to cover risks and the need to provide owners with an adequate return on their investment. However, as

ownership interests (be it through a share or a policy insurance contract) in mutual insurers are non-transferable and non-negotiable (cooperatives), market control mechanisms such as the threat of takeover, the possibility of management oversight and guidance by a majority of shareholders, or the use of stock options as incentive measures are limited, if not completely lacking. Thus, the discretionary power of management in mutual insurers may be more extensive than in stock companies, unless counterbalanced by some other control mechanisms. These limitations have to be taken into account when elaborating an appropriate corporate governance structure for mutual insurers.[4]

16. Another potential agency conflict arises from the marked *asymmetry of information* and power between policyholders and management.[5] The complexity of many insurance products and the varying duration of contracts lend themselves to various interpretations regarding particular contract clauses and make comparing different insurance policies an arduous task. Information may not be reported in an easily understood fashion and individual policyholders may lack the expertise needed to sift among various technical parameters of contracts. Policyholders and insurance beneficiaries are also a dispersed group, with little power to compel management to take certain actions. Without appropriate governance standards and other safeguards, their options may be limited to choosing not to take out a policy, choosing not to renew a policy, or seeking legal redress, which may be sub-optimal and can entail high costs.

17. The problem is further complicated by structural changes in the financial services landscape. Mergers and acquisitions within the insurance sector and others combining insurance entities with other types of service providers have resulted in large financial groups with opaque structures. The increasing number of cross-holdings between financial institutions may tend to cloud the visibility of information on entity situations for policyholders and other non-specialists.

Specificity of life insurance, non-life insurance and reinsurance

18. In addition to the conflicts of interest common more or less to all insurance entities, other governance issues arise in the context of specific branches of activity. Some issues may develop in life insurance, some in non-life, and others in reinsurance.

19. Life insurance establishes contractual relations over a number of years between an insurer and the life policyholder or the latter's beneficiaries, which is similar in many respects to the fiduciary relationships of pension funds. Major problems of governance stem, *inter alia*, from an insurer's viability as a going concern, and from the behaviour of its officers. Over a long period of time, many parameters of policy pricing may change, including mortality rates for the insured, returns on investments, and inflation. Given all these uncertainties, the potential for conflicts of interest between insured and insurer over the duration of a contract is non-trivial, in the absence of other types of countervailing controls.

20. In contrast to life insurance, most non-life insurance business[6] is regarded as having a shorter cycle of operation, one to three years in the majority of cases. Consequently, the potential conflict of interest between policyholders and shareholders is less obvious than in the life business. The problems of governance with non-life insurers stem from information asymmetries between policyholders and insurers, and from the discretionary power of management. These two factors may lead management to make opportunistic short-term decisions that have adverse implications for policyholders and shareholders.

21. In the case of the reinsurance business, the insured are themselves insurers and, thus, in principle possess adequate information and expertise about the underlying products. Partly for this reason, reinsurers are less regulated and supervised than direct insurers in some jurisdictions whereas in others the rules of supervision (licensing, minimum solvency requirements, sanctions) are largely, if not exactly, the same as those applicable to direct insurers. Be that as it may, the international nature of reinsurers' operations makes it difficult for a single national authority to supervise them, which suggests a need for enhanced co-

operation and co-ordination among different supervisors, as well as sound governance structures and internal control mechanisms for the reinsurers themselves.[7] However, the fact that the asymmetry of information is less an issue between insurers and reinsurers than between standard consumers and insurers should be kept in mind when interpreting the guidelines concerning the protection of stakeholders.

22. More generally, the complexity of the insurance business has entailed in most OECD countries the development of a specific function – the actuary – in order *inter alia* to control and assess the solvency of insurers' activities and the accuracy of technical provisions. Although the specific position and duties of actuaries vary across jurisdictions, the role of the actuary in the corporate governance of insurers has become paramount in the life sector and is increasingly developing in the non-life sector in most OECD countries[8].

The role of prudential regulation and supervision in the governance of insurers

23. Finally, as underlined earlier, the governance structure of insurers has to take into account the very specific and evolving regulatory framework within which their activities are performed. As in the rest of the financial sector and because of the role of insurance in the economy, its regulation and supervision have played a key role in shaping its governance structures and mechanisms. Rules generally have been designed to prevent default and to protect the interests of policyholders, the insured and the beneficiaries of insurance contracts, as well as any third parties that may have direct claims against an insurer under an insurance agreement. The risk is that in the quest for safety and soundness policymakers may impose rules that are overly restrictive or prescriptive and for years regulatory authorities effectively left only modest leeway to market mechanisms to counter conflicts of interest. This point is illustrated by the debate concerning the choice of a quantitative approach or a "prudent person" approach to regulation of the investments of life insurance entities[9]. More recently, given the globalisation of the insurance industry and the convergence of the financial sector, prudential standards and the dissemination of information are being determined more and more at an international and/or regional level.

Good governance of insurers: a complement to the regulatory prudential framework

24. A strong prudential regulatory regime is at the forefront of the governance framework for insurers. A sound legal and regulatory environment helps to protect policyholders from most of the major conflicts of interest arising in the insurance sector, and, in particular, to maintain the sector's financial soundness. However, regulatory authorities must be cautious not to impose highly restrictive rules and wide-ranging prohibitions that severely restrict the discretionary powers of corporate executives. It is ultimately the Board's role and function to manage the entity and make appropriate commercial decisions. Criticism in the past about the restrictive nature and cost of regulation has led authorities in most OECD countries to tailor prudential regulation and supervision to the actual risks facing entities on a case-by-case basis. In practice, these changes in the approach to supervision and regulation typically give insurance executives more latitude to formulate and justify their strategies and to manage risk, and they underscore the importance of internal control mechanisms within insurance entities.

25. Some would argue that the more flexible approach to external supervision of insurers may not be sufficient on its own to prevent poor risk management and the chance that certain insurance entities will subsequently fail. Assuming the protection of individual policyholders is the aim of most regulatory provisions in the OECD countries, there is a need to supplement prudential supervision with appropriate standards of conduct and other governance mechanisms. In practice, the greater degree of flexibility on the part of (re)insurers' managers, along with the heterogeneity of regulatory provisions according to the branch of activity and of forms of ownership, has given rise to governance structures that are differentiated and sometimes lack adequate transparency vis-à-vis all stakeholder groups. The relative opaqueness of the structures and mechanisms of the corporate governance of insurers – especially at times of crisis – is an

additional risk factor that calls for a more systematic approach to guidelines on governance in the insurance sector.

B - DETAILED ANNOTATIONS

Guideline 1. Identification of responsibilities

An insurance entity is generally established in accordance to statutes, by-laws or contracts. These documents should clearly define the legal form of the entity: corporation, mutual, co-operative, provident societies or Lloyd's, as well as the lines of business underwritten (life, non life, reinsurance) and the main objectives of the entity. These objectives may vary according to both the legal form of ownership and the type of business. The responsibilities of any corporate body (board of directors, supervisory board, executive board and senior management) should be stipulated.

Guideline 2. Board(s) structure

Each insurance entity is directed by a governing body that is responsible for the operation and oversight of the insurance entity. This governing body may be single or dual. Actually in some cases it can be appropriate to split the operational and oversight responsibilities between a supervisory board that oversees the activities of the board and elect its members.

The Board may also form Committees to perform defined tasks, primarily audit, risk management, compensation or nomination committees, (but also financial or screening committees etc.). If so, the committees' composition, responsibilities and resources vis-à-vis the general meeting and the board of directors (and/or the supervisory board) must be stipulated. The committees report to the Board on their activities and findings. The overall responsibility for delegated duties remains, however, with the Board.

Guideline 4. Composition and suitability

The requirement concerning outside directors may also be replaced by the existence of a bicameral structure and of a supervisory body as aforementioned, as far as this body also ensures an independent control on the Board's decisions and activities. Some countries may wish to impose more stringent and precise rules requiring that a majority of directors be non-executive and independent of influences that may limit their capacity to provide objective oversight on the entity.

Besides two cases need to be distinguished for mutual insurers. On the one hand, mutual insurers with basic structure where participating policyholders have non transferable rights and exercise a limited control on the board and, on the other hand, mutual insurers with bicameral structure.

In the former case, the limited power and control that is often exercised by dispersed participating policyholders that do not benefit from "stock market control" advocates for more oversight of the board activities and decision from independent agents like outside directors. For instance, in Belgium, there is an Agreement (that mutual insurers may apply or not), which states two outside directors should be part of the board of a mutual insurer. It should also be noted that there is a difference in the control that may be exercised by corporate policyholders (e.g. ship-owners), who may be very few and powerful, and numerous and possibly dispersed individual policyholders.

In the case of a bicameral structure, the governing body of mutual insurers is usually controlled by a supreme body which is composed, for instance according to German Insurance Supervision Law, by an assembly of members or of elected representatives of members. This supreme body includes *inter alia* professional members that are meant to be a substitute to the control exerted by the markets in the case of stock companies. The establishment of this structure seeks to limit the discretionary power of managers compared to participating policyholders. Moreover, the existence of another independent body that oversees the decisions and activities of the Board of mutual insurers may also be considered as a substitute to the existence of outside directors on the board.

For these two reasons, any requirements concerning the composition of mutual insurers board needs to be adapted according to the particular circumstances of the jurisdictions and to the type of mutual insurers concerned.

Concerning the composition of the board in general, if the insurance entity has significant operations abroad, the Board should include members with international experience or from abroad.

The disclosure of the amount of the compensation of the board members may also be considered in order to increase the transparency and responsibility of the Board's functions.

The qualifications and experience required of the members of the governing body should depend on their responsibilities and functions in the board. In some OECD countries requirements are also set up by the law for outside directors. In other countries, the qualifications of outside directors are left to the appreciation of the insurance entity.

Where it lacks the expertise needed to make sufficiently informed decisions and assume its responsibilities, the governing body could be required to seek the advice of designated experts or professionals to perform those duties, although it should not transfer its responsibilities to such persons.

Members of the governing body should not be in an employment relationship with the supervisory and regulatory authorities. The by-law of the entity or any documents related to them should also address the multiplication of mandates.

The continuation of education and training of Board members should, if required, also be ensured in relation to their respective responsibilities.

Causes of disqualifications include being subject to disciplinary restrictions by professional bodies such as disqualification by a national actuarial association or having restrictions placed on the types of entities that an auditor can overview.

Guideline 5. Accountability

Accountability over governance functions is particularly important in order to allow the insureds and shareholders or participating policyholders and/or the supervisory authority, to discipline the governing body or seek other means of redress in case of mismanagement.

In some OECD countries the Board is only accountable to the supervisory authority and not to the policyholders. However policyholders may file a claim to the competent court if they are dissatisfied with the Board's management of the insurer or of their contracts. In most others, the Board is first accountable to its shareholders and policyholders.

Guideline 6. Actuary

Actuaries play a major role, *inter alia*, as experts in the risks incurred by the insurer, in controlling the quality of the information the insurer discloses to its owners or participating policyholders and to the supervisory authorities, and in protecting the insured. The degree to which the regulations in OECD countries determines the actuary's place and function varies, but the trend in recent years has mainly been towards a strengthening of their powers both in the life and non-life sectors.

Actually, the regulations of most OECD countries require that an entity operating in the life insurance market retain the services of an outside or in-house appointed actuary. However, it should be noted that another model than the appointed actuary has also been developed in a few countries. In this case, the model of the appointed actuary is accurately replaced by a model where the function of the actuary is performed on the one hand by the top management of life as well as non life insurance entities who have generally - but not compulsorily - actuarial skills, and on the other hand by the supervisory authority whose staff also has actuarial skills. Nevertheless this model might be difficult to reproduce elsewhere since it requires a supervisory oversight with powerful means and well-qualified staff.

The model of the appointed actuary is also more developed in the life sector owing to the long duration of life insurance contracts and to the necessity to ensure an appropriate level of provisions over a longer period. The appointment of an actuary is therefore only required in the life sector in most OECD countries. However, the complexity of the insurance business in the non-life sector as well and the risks stemming from an asymmetry of information between management and shareholders/participating policyholders/policyholders, advocates for actuarial advice also in this line of business – at least in so far as suitably qualified actuaries are available in the concerned market. Accordingly, in non-life insurance, the role of the actuary has expanded in a number of countries in recent years and could be enhanced further in coming years.

Besides, the actuary's appointment may be subject to supervisory review. In this case, an unsatisfactory review can be sanctioned by removal. Removal may be required where the actuary fails to perform adequately the required functions and duties or does not meet eligibility or fit and proper criteria. The entity should generally notify the supervisor of changes in actuary staffing.

The actuary should also be appropriately qualified in respect of specific professional and personal requirements and in adequation with the supervisory framework of the concerned jurisdiction. In many OECD countries, there are explicit criteria regarding who may qualify for appointment as an actuary. These criteria may be based on qualifications, professional experience, competence and integrity and membership in a professional association or a combination of these elements. In some countries, the actuary is also submitted to a Peer review process. Finally, the actuary should be able to operate its activities in an independent way. Independence of the actuary may be understood in different ways according to jurisdictions' circumstances, but in particular to avoid possible conflict of interest, it seems, for instance, preferable that the actuary would not be permitted to hold his/her position at the same time as being a chief executive officer.

In addition to the traditional role of calculating technical commitments and/or assessing the values of tied commitments, the solvency margin as well as the compliance with accounting rules, and depending on the regulations of the country in question, other tasks or advisory functions may also be assigned to the actuary such as: solvency supervision, certification of documents sent to the supervisory authority, certification of the calculation of premium rates and technical provisions, advice to management, supervision of the distribution of profits to policyholders, accuracy of the risk assessment policies, suitability of reinsurance arrangements and of the investment policy, statistical inference and stress testing of the future financial condition of the entity. Moreover these tasks and responsibilities can change over time, taking into account the availability of suitably qualified actuaries and the quality of the profession's organisation as well as the extent to which the actuary is subject to professional standards of practice, qualification standards and obligations on professional conduct.

One of the key trade-offs at stake in the appropriate fulfilment of the actuarial functions inside insurance entities, lies on how to find the right balance between the actuary's independence in its assessment of the situation of the insurers and the appropriate management and board's responsibility and accountability. To this extent too much independence of the actuary might mean that the management or the board may too heavily rely on another agent - the actuary - to take decisions and responsibility in the management of the firm. On the other hand, reduced independence of the actuary may increase the discretionary power of the managers, or top managers, and limit his possibility to correctly gauge the risk exposure of the insurer and exercise, if relevant, his whistle-blowing function.

Considering both this complex relationship between the management of the insurer and the function of actuary and the necessity for insurance activities of this technical advice, any requirement concerning the role and the independence of the actuary should be adapted to the circumstances of the market, business culture, means of the supervisory authority, of a given jurisdiction. However the whistle-blowing function should remain a basic function as far as it helps strengthening the confidence of the market and the authorities while enhancing the actuary's leeway.

Accordingly, some countries may deem it relevant to also require from the actuary nominated in one entity, as a second step of its whistle –blowing function, to report to the supervisory authorities in case the board or the management would not have taken remedial measures after his/her first warning. This possibility does not imply however any sharing of responsibility of the actuaries' legal duties with the Supervisory Authority.

Attention may also be paid in the governance framework to the respective roles, functions and relationship of actuaries with external auditors.

Guideline 7. External Auditors

The independence of the auditors has to be interpreted in the general context of the concerned jurisdictions. In this respect, insurance auditors should be specifically licensed by supervisory authorities in addition to complying with general statutory requirements. They are appointed by the governing body, the general meeting of the shareholders or meeting of member representation if relevant.

In order to ensure and improve the independence of auditors, many countries have for instance banned or at least strongly restricted the possibility for auditors to provide other services to their clients than their core auditing activity. In the cases where such –limited- non-auditing activity is allowed, careful attention is generally paid to the assessment of the specific circumstances of this task and in particular to the nature of the service provided and the systems of safeguards put in place to avoid undesirable conflict of interests. For instance, in some countries, these non-auditing services may be performed provided that the fact that the auditor is performing these activities and also the fee that is being paid for these services, are publicly disclosed.

An auditor' s term of office renewal might be considered for instance provided the partner in charge of the entity can be replaced by another partner belonging to the same auditing company.

Insurance auditors apart from their general statutory duties should verify the compliance with supervisory laws, regulations and instructions.

External auditors whistle blowing functions do not imply that the supervisory authority share a responsibility with the specific certification function of the auditors.

II – Internal Governance Mechanisms

The scope and complexity of internal control measures will vary according to the type and size of the insurance entity. For instance, in the case of composite insurance entities the internal controls should be split between life and non-life activities.

Reinsurers should also develop internal controls particularly tailored to the risks inherent to their lines of business. In particular, reinsurers should develop appropriate polices and procedures covering underwriting in the risks carried out by the concerned policies, accumulation of exposures, provisioning (and particularly IBNR provisions), retrocession, contract conditions, contracts, investments. A distinction could also be made between reinsurer of life business and reinsurer of non-life businesses. In the former case as for life insurers the risks last over a longer period of time implying that many variables may evolve and have therefore to be taken into account in the risk assessment process.

III- Stakeholders' protection

Guideline 10. Protection of participating policyholders in the case of Mutual insurers

As afore-mentioned in the annotations on the Board structure, mutual insurers can be organised through two main forms, a simple structure and a bicameral structure. In the latter case, the views of members are indirectly represented through their board of representatives. This case is thus reflected in the text of the guidelines. It should also be mentioned that the content of this guideline may also need to be adapted to the scale of a mutual insurer business.

Moreover, it should be noted that this guideline only addresses the protection of participating policyholders. However, in some mutual insurers, there can be non-participating policyholders who have different position in the governance structure in respect of the control of the insurer's management. In Belgium, for instance, most mutual insurer are so-called "impure mutuals" meaning that insureds have no manager's rights and typically may not participate in the General meeting or have that right provided their rate premium exceed a certain amount set by the by-laws. However, these "impure mutuals" still retain the main characteristics and possible conflicts of the mutual insurers' structure in so far as no stock market controls limit the discretionary power of managers.

Besides this guideline should also apply to stock companies operated on mutual grounds in Sweden. These are usually owned by other financial institutions or organizations and do not distribute profit to shareholders. Instead their surplus is handled in the same way as in mutual insurers. Besides, the federal regime in Canada provides participating policyholders, who are entitled to participate in the profit of a stock company by receiving dividends, rights to participate in the governance of an insurance entity, including rights to vote, make proposals and elect directors, in both mutual insurers and stock companies. Insurers issuing par policies must also meet certain regulatory requirements with respect to the par account.

Guideline 11. Disclosure

Disclosure may also include in some countries: major share ownership and voting rights; members of the board and key executives, and their remuneration; material issues regarding policyholders, employees and other stakeholders; significant strategic alliances and outsourcing arrangements between the insurer and third parties; future quantifiable potential of identifiable intangible assets (e.g. capital expenditures on research & development, investment on training and advertising campaigns).

Information transparency towards policyholders *inter alia* in the process of the sale of the insurance policies could also cover premiums, investment policy and returns (in the case of life insurance products with variable saving components).

Besides, it is worth mentioning that disclosure requirements for insurance entities are also being developed in the frame of the International Financial Reporting Standards by the IASB.

Guideline 12. Redress

Informal redress channels may offer many advantages, including the lower cost to consumers, and potentially, quicker resolution of the matter. Litigation, while potentially highly effective in sanctioning mismanagement, can be excessively costly for individual consumers, though it may be appropriate in the case where an entire group (e.g. an employment association) is affected.

NOTES

1 Prudential regulation and supervision play a role at the various levels at which conflicts of interest can arise between insurers and the insured. Information asymmetry and risks of adverse selection when contracts are taken out, and throughout their lifetime, are being potentially reduced by the development of contract law, compulsory insurance and (prior or ex post) pricing review in the OECD countries. Risks or uncertainties regarding the insurer's capacity to meet its commitments over the long term, which characterise life insurance in particular, are limited by the development of regulations on licensing, fit and proper management, solvency and insurance entity investments. In addition, to preserve policyholder rights in the event of an insurer bankruptcy, many OECD countries have instituted general or specialised policyholder protection funds. Finally, in the event an insurance entity falters or fails, the regulations of the OECD countries stipulate rehabilitation or sanction procedures at a variety of levels, specifying the potential means of redress available to policyholders, as well as any liability of the officers and directors of the entity in question.

2 In order to take account of these different types of ownership, they will be referred to as "insurer" or "insurance entity" in the rest of the document and in the guidelines.

3 Mutual insurers may actually take two different legal forms: a mutual or a cooperative. A cooperative is a capital stock entity whose shares must be held by its employees or customers (policyholders in this case). The main difference with a stock company is that the shares of a cooperative cannot be negotiated and therefore the entity cannot be quoted. On the other hand, a mutual is an entity without capital, hence without shares or shareholders. A mutual has no owner as such but is managed collectively by its policyholders. Mutuals cannot thus be redeemed or quoted. In the rest of the document, the wording "mutual insurer" will be generally used to reflect the situation of both legal status _ mutuals and cooperatives although some adaptations are specified when relevant.

4 Actually, in spite of a trend towards demutualization in the 1980's and 1990's and the formation of mutual holding companies, the insurance market is still the part of the financial sector with the largest presence of mutual insurers. Some classes of business are handled almost exclusively by this type of organisation, which seems best suited to cover certain specific risks. This is the case with ship insurance in the United Kingdom, 90% of which is written by mutual insurers. The market share of mutual insurers in the global insurance market was 25% in 2001, with a more important proportion for non-life insurance (31%) than for life insurance (20%).

5 It may be noted that the insurer is also in a situation of information asymmetry vis-à-vis the potential policyholder, not knowing the latter's degree of risk aversion, real exposure to risk or behaviour in the event of becoming insured. From this want of information stem the well-known problems of adverse selection and moral

hazard—problems which insurers endeavour to alleviate through experience, better differentiation of policies in order to profile applicants, deductibles and co-insurance arrangements.

[6] Apart *inter alia* from medical indemnity and public liability which are considered long-tail business.

[7] In this perspective, the work undertaken by the OECD and the IAIS in order to enforce a more global approach and oversight on reinsurers may be stressed. The IAIS approved in 2002 principles on minimum requirements for supervision on reinsurers and has endorsed a standard on supervision of reinsurers in 2003 that mentions that the corporate governance of reinsurers should be at least of the same quality as the direct insurers. The OECD has established under the Council Decision on the Exchange of Information on Reinsurers endorsed in July 2002, a specific and secured network aimed at confidentially exchanging information between OECD governments on reinsurers. This mechanism is designed to improve the transparency and accurate assessment of the soundness of reinsurance markets.

[8] See in the Annotations to the guidelines, the sixth relative to the actuary for further detail on the actuary role and function.

[9] Even though in practice in OECD countries, both approaches often turn out to be not that different in their application.