International Association of Insurance Supervisors

Organisation for Economic Co-operation and Development

Issues Paper on Corporate Governance

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This document was prepared in consultation with IAIS Members and Observers and the Governance and Compliance Subcommittee and the OECD Insurance and Private Pensions Committee

This publication is available on the IAIS website (www.iaisweb.org) and the OECD website, (http://www.oecd.org/daf/insurance/governance)

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Introduction

1. The International Association of Insurance Supervisors (IAIS) and the Organisation for Economic Co-operation and Development (OECD) have agreed to issue a joint issues paper on the corporate governance of insurers.

2. Some topics covered in this paper are also dealt with in other IAIS and OECD papers. This issues paper is distinct in having an insurer corporate governance focus and discusses a variety of topics from this perspective. Material on topics discussed in other IAIS papers is included in the issues paper in order to provide a complete picture of insurer corporate governance issues. Throughout the paper relevant topics are addressed in a manner which is consistent with existing IAIS and OECD work. Further detail and/or direction on other aspects of these topics are available in the other papers[1].

3. The OECD published *Guidelines for Insurers' Governance* in 2005 as a complement to the *OECD Principles of Corporate Governance*[2]. The guidelines provide governments and the insurance industry with a roadmap for promoting insurer corporate governance, and thereby better protecting policyholders and other stakeholders. The OECD's two main objectives in drafting the guidelines were:

- to enhance the protection of policyholders and shareholders beyond the protection already provided by existing regulation and supervision

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[1] Other relevant IAIS documents (available on the IAIS website, www.iaisweb.org) include: Supervisory Standard on Licensing (October 1998), Supervisory Standard on On-Site Inspections (October 1998), Supervisory Standard on Asset Management by Insurance Companies (December 1999), Supervisory Standard on the Evaluation of the Reinsurance Cover (January 2002), Standard on Supervision of Reinsurers (October 2003), Guidance Paper on Public Disclosure by Insurers (January 2002), The Use of Actuaries as Part of a Supervisory Model (October 2003), Guidance paper on Stress testing by Insurers (October 2003) Guidance Paper on Investment Risk Management (October 2004), Standard on Disclosures concerning Technical Performance and Risks for Non-life Insurers and Reinsurers (October 2004), Supervisory Standard on Fit and Proper Requirements and Assessment for Insurers (October 2005), A new framework for insurance supervision: Towards a common structure and common standards for the assessment of insurer solvency (October 2005), Standard on disclosures concerning investment risks and Performance of Insurers and Reinsurers (October 2005), Standard on disclosures concerning technical risks and performance for life insurers (October 2006), Standard on Asset-Liability Management (October 2006), Standard on enterprise risk management for capital adequacy and solvency purposes (October 2008), Guidance paper on enterprise risk management for capital adequacy and solvency purposes (October 2008), Principles on group-wide supervision (October 2008), Standard on the use of Internal Models for regulatory capital purposes (October 2008), Guidance paper on the use of Internal Models for regulatory capital purposes (October 2008), Standard on the structure of regulatory capital requirements (October 2008), Guidance paper on the structure of regulatory requirements (October 2008), Principles on Group-Wide Supervision (October 2008). Annex 2 provides further detail on the most relevant of these IAIS papers. See also footnote 2.

[2] The OECD *Principles of Corporate Governance* were endorsed by OECD Ministers in 1999 and have since become an international benchmark for policymakers, investors, corporations and other stakeholders worldwide. The *Principles* have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries. The *Principles* are one of the twelve key standards for sound financial systems of the Financial Stability Forum. The *Principles* also provide the basis for an extensive programme of cooperation between OECD and non-OECD countries and underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes. The *Principles* were revised most recently in 2004. Annex 3 provides further detail on relevant OECD papers.

- to develop guidance specifically directed to the insurance sector that would supplement corporate governance rules generally applicable to non-insurer companies.

4. The Insurance and Private Pensions Committee (IPPC) initiated a review of the guidelines in 2008, as mandated by the OECD Council. To this end and to facilitate coordination with the IAIS, an ad hoc IPPC Task Force on the Governance of Insurers (IPPC Task Force) was formed.

5. Similarly, since its inception in 1994, the IAIS has developed a number of principles, standards and guidance papers to help promote the development, both domestically and globally, of well-regulated insurance markets. Central to this objective is the common framework[3] for insurance supervision that establishes a structure within which standards and guidance may be developed. Governance is one of the elements of the framework.

6. The IAIS *Insurance Core Principles and Methodology* (October 2003) set out essential principles that should be in place for a supervisory system to be effective and serve as a basic benchmark for insurance supervisors in all jurisdictions. Insurance Core Principle 9 states that "*The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards"*.

7. In 2006-07 the IAIS Corporate Governance Task Force reviewed existing corporate governance guidance, including material prepared by the IAIS, Basel Committee on Banking Supervision, International Organisation of Securities Commission, OECD and self-regulatory entities. This resulted in a document, *Main Elements of Insurer Corporate Governance* (October 2007).

8. In 2008 the IAIS and the OECD conducted a joint survey on the corporate governance of insurers to obtain information on current practices and views on what might constitute good practices. The World Bank compiled the responses and prepared a survey report that provides a high-level summary of the responses. The survey report is available on the IAIS and OECD websites. The IAIS and OECD also held a roundtable on the governance of insurers in Paris on 5 December 2008. The roundtable provided further insights into recent developments in the governance of insurers, identified key issues and offered the opportunity to understand further the perspectives of different stakeholders.

9. This paper builds on the OECD *Guidelines* and the IAIS *Main Elements of Insurer Corporate Governance,* and is informed by answers to the IAIS/OECD survey and by the joint IAIS/OECD roundtable and by the supervisory experience of the members of the subcommittee. It is also informed by the lessons learned in the context of the 2008-2009 financial crisis, including compensation practices and their impact on governance related issues.

10. By describing essential components of an insurer's corporate governance framework, this paper aims to provide a basis for further work by the IAIS and OECD. To this extent, the paper also aims to contribute to improving regulatory and supervisory

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3 *A new framework for insurance supervision: Towards a common structure and common standards for the assessment of insurer solvency* , (October 2005)

efficiency. Governance ultimately influences an insurer's risk profile. The way an insurer governs itself can affect its decisions, practices and risk profile. As shown by the survey, weak insurer corporate governance is seen by supervisors as a key reason for insurer failures. Thus, effective corporate governance can assist the supervisor, making it possible for the supervisor to have greater confidence in the work and judgement of an insurer's board, senior management and control functions. As such, it enhances the supervisor's ability to supervise an insurer effectively and protect policyholder interests. To bring about this increase in effectiveness, supervisors must have the resources and ability to assess the effectiveness of an insurer's governance framework. This paper will identify issues relevant in determining if an insurer's governance is sound and appropriate for the nature, scale and complexity of the business and its overall risk profile and assess if it is being adequately implemented.

11. The quality of insurer corporate governance has generally improved over the last decade. In particular, improvements have been made to:

- structure of the boards of directors
- reporting to the board
- public disclosure
- board and management awareness of the importance of good corporate governance, for instance control functions and conflicts of interest.

This can be attributed to many factors, including developments in laws and regulations on governance in many jurisdictions and advancement of best practices across borders. There is, however, still considerable room for improvement, including in terms of the application of governance principles.

12. This paper does not prescribe any particular rules or framework but rather provides background and explores the main issues relevant to the corporate governance of insurers. For the IAIS, it will serve as the basis for a supervisory paper and as input for revising the *Insurance Core Principles.* The OECD will use the report when reviewing its corporate governance guidelines for insurers' governance.

13. The IAIS and OECD are striving to develop harmonised guidance and promote a consistent approach among regulators and supervisors. In particular, these organisations want to avoid duplicative or contradictory requirements and reduce the possibility of regulatory and supervisory arbitrage.

14. The topics discussed in the issues paper should be interpreted in the light of the principle of proportionality. This principle requires the provisions of a supervisory regime to be applied in proportion to the nature, scale and complexity of the insurer and to the risks to which the insurer is exposed. Supervisors may find that it is appropriate to establish minimum governance requirements for all insurers and then use additional practices for more sophisticated insurers, in line with the principle of proportionality. Supervisors may also find that practical application of the corporate governance principles vary depending on, among other things, the specific legal and economic circumstances in their jurisdictions and conditions that prevail in their markets.

15. The paper addresses governance issues applicable to insurers on a solo basis as well as at the group level. It is important for insurers belonging to a group or a conglomerate to consider the governance issues discussed in this paper not only at the parent company level, but also at the group level, taking into account the nature, scale and complexity of the risks held in each subsidiary and the group as a whole.

Additionally groups may operate in jurisdictions with different legal requirements and therefore the governance structures may not be completely uniform across the group.

16. This paper refers to a corporate governance structure composed of a board of directors, senior management and key control related functions. The terminology “board of directors” and “senior management” is used in a functional and not a legal sense. The term “control functions” indicates those functions serving a control or checks-and-balances function from a governance standpoint. “Governance” as used in this paper refers to the overall framework under which an insurer governs itself, including the insurer’s activities in terms of risk management, compliance, audit, and actuarial matters.

Summary

17. As indicated in the introduction, the topics discussed in this paper should be interpreted in the light of the principle of proportionality and recognising that there are differences among jurisdictions. Core elements of corporate governance discussed in this paper includes:

- governance structures:
    - role of the board in setting strategies and policies and overseeing senior management
    - reliance on board committees for delegated board functions
    - the definition of fit and proper criteria for executive and non executive board members
    - independence of decision making
    - groups and conglomerates.
- functions of the board:
    - setting of strategies and policies, delegation and reporting
    - board responsibilities in the areas of corporate governance, ethics and business conduct and conflicts of interest
    - remuneration and possible perverse incentives leading to unacceptable risk taking
    - qualifications and training of board members
    - board accountability.
- control functions:
    - risk management, compliance, internal audit and other control functions as an integral element of a sound governance system
    - relation of corporate governance with solvency issues (internal modelling, stress testing etc)
    - use of rating agencies
    - staffing and independence of control functions
    - reporting to the board and whistleblowing.
- the actuarial function and auditors:
    - qualifications and independence.
- disclosure and transparency:
    - better developed disclosures on corporate governance.
- relationship with stakeholders:
    - insurer’s key stakeholders include owners as well as policyholders, supervisors and employees
    - participating policyholders as a special class of stakeholders

    - insurers’ responsibility to society – corporate social responsibility.
- interaction with the supervisor:
    - effective corporate governance can assist the supervisor, by making it possible for the supervisor to have greater confidence in the work and judgement of an insurer’s board, senior management and control functions. This contributes to the supervisor’s ability to protect policyholders’ interests.

18. In addition to several generally accepted corporate governance elements discussed in this issues paper, future IAIS papers will also address the evolving nature of corporate governance, especially the lessons learned from the recent crisis in the financial markets:

- board members need more in depth knowledge, clearer responsibilities and closer involvement in the oversight of the insurer and in setting its risk appetite. This issue addresses both executive and non executive board members. Fit and proper criteria need to be addressed in this context
- the position of board members needs to be further “professionalised” (ie clearer and higher standards of conduct and practice). Board members need to be more aware of their responsibilities and the effort they need to make (including possible training) to meet those responsibilities. This also has implications for the functioning of board committees
- the issue of remuneration within insurers needs to be considered. In the past, systems have been in place that did not always provide the right incentives for management at all levels in the insurers
- the role of control functions needs to be enhanced from a governance perspective. Their relative position in the balance of powers of insurers needs to improve
- insurers need to conduct their own due diligence and not make investment or other decisions or base their risk management solely on third party assessment, such as credit ratings

Foundation of corporate governance

19. As the term suggests, corporate governance is the system by which an insurer governs itself. This includes:

- corporate culture and environment (values, ethics, ease with which employees raise concerns or report irregularities, etc.)
- corporate structures (board of directors, senior management, business area functions, etc.)
- essential governing documents and policies (by-laws, organisational rules, committee mandates etc.)
- strategies, policies, procedures and controls (covering risks to which the insurer is exposed as well as risk management, compliance, audit, financial reporting, etc.)
- decision making and actions linked to this culture, environment and framework of structures, policies and controls.

20. Corporate governance defines roles, responsibilities and accountabilities. It clarifies who possesses the duty and the legal power to act on behalf of the insurer and under which circumstances. It sets requirements for documenting decisions and actions, along with their rationale, and for disclosing this to stakeholders. It provides for corrective action for non-compliance or weak oversight, controls and management. Thus corporate governance is about the allocation and regulation of power and accountabilities within an insurer, and includes avoiding undue concentration of power. This is often referred to as a system of "checks and balances" reflecting the fact that while an insurer has to be flexible and responsive in order to make timely decisions, it also has to be transparent and have appropriate systems, controls and limits to ensure that power is used in the best interest of policyholders and the insurer as a whole.

21. The survey results showed that the most frequently identified governance issues associated with the failure or near failure of insurers are poor governance (generally) and weak internal controls and risk management. A board is responsible, more than ever, for understanding and guiding the insurer's strategy and risk appetite with respect to complex risks and the financial instruments intended to profit from or hedge against that risk. Recent events suggest that, for a variety of reasons, some boards were not well informed, did not understand, or did not have the appropriate knowledge of the financial obligations and risks faced by the insurer. In other cases priority was given to short term gains rather than policyholder's interests. Boards often know much less about an insurer's financial condition than management. Consequently, due regard must be given to the qualifications of individual directors, their knowledge of the business, their ongoing training needs, the promotion of ethical and responsible behaviour and decision making and their accountability and independence.

Governance structures

Different board structures

22. Governance structures for insurers differ amongst jurisdictions. Despite the differences, there are two key functions that commonly need to be carried out:

- overall strategy and oversight
- execution and management.

These functions can either be entrusted to a single body or spread over separate bodies.

23. In many jurisdictions, the corporate body responsible for oversight and overall strategy and policy is the board of directors (the "board"). Other names for the board include the statutory board, external board, supervisory board, administrative board, or board of governors or overseers.

24. The board relies on the body responsible for executing decisions made by the board and for managing the insurer on a day-to-day basis. In this paper this body is referred to as "senior management". It is also known as the executive board or executive committee.

25. General corporate governance principles have a special application to insurers because of the nature of their business and the special responsibilities to policyholders and society as a whole.

One-tier and two-tier boards

26. Members of the board are sometimes referred to as "directors". In some jurisdictions an insurer's board includes both:

- "inside" directors, often referred to as "executive directors", are managers and employees of the insurer
- "outside" directors, sometimes referred to as "external directors" or "non-executive directors", are independent or disinterested board members.

The latter are normally not employees, owners or other direct stakeholders in the insurer. In order to promote the independence of decision making of the board, outside directors are independent of not just the insurer but the group to which the insurer belongs.

27. One-tier boards typically have overall responsibility for the insurer but are allowed, by law, to delegate the managing of the insurer to a designated president or chief executive officer (CEO) or to a collective of managers.

28. In some jurisdictions insurers are required by general company law or other regulation to spread the board function over two formal bodies usually called a supervisory board and a management board. This board structure is called a two-tier system. In a two-tier system the supervisory board is responsible for overall strategy and oversight whilst execution and management is carried out by a management board whose chairman sometimes is also referred to as CEO. Where powers, duties, qualifications, independence and responsibilities of the board are concerned in this issues paper these features may apply to one or both bodies depending on the relevant subject (eg in a two-tier system only the supervisory board may form board committees and its members are drawn from this body).

29. In recent years, these two approaches have trended towards one another. For example, legislation has been introduced in jurisdictions with one-tier boards prohibiting inside or executive directors or limiting their number. Other jurisdictions with supervisory boards have changed the law to give these boards more strategic responsibilities.

Powers, duties and responsibilities

30. The exact role of the board is determined by the powers, duties, and responsibilities delegated to it or conferred upon it by law or regulation. These matters are typically specified in the insurer's by-laws and organisational rules. Usually the insurer's by-laws specify the number of members of the board, how they are to be chosen, the frequency and mode of meeting and how decisions are to be made. The by-laws primarily contain what is prescribed in legislation. The insurer's organisational rules further specify the roles and responsibilities of the board, senior management and other corporate bodies and functions.

31. Directors must be individuals, in most cases elected by the owners or shareholders (or, in the case of mutuals, member-policyholders) of the insurer. In other cases, directors may be appointed. Typically the board chooses one of its members to be the chair.

32. Members of the board have a duty to act in good faith and exercise their powers in the best interest of policyholders, shareholders and the insurer as a whole, in compliance with the law. Directors may not allow their own personal interests to come before or conflict with the interest of the insurer. This is discussed in more detail later under *Conflicts of duty or interest.*

33. The legal responsibilities of boards and board members vary with the nature of the insurer and with the jurisdiction in which it is incorporated or operates. For publicly listed companies, these responsibilities are often more rigorous and complex due to specific additional governance codes or requirements, and include continuous reporting obligations. The ownership structure of the insurer also has implications for director appointments, director independence, and the operation of board committees.

Qualifications of board members

34. Today's boards need to understand complex issues related to insurance business, actuarial science, accounting, law, computer models and management compensation. The recent financial market crisis has highlighted the need to have good quality board members with integrity, relevant knowledge and expertise. The quality of individuals and their behaviour, as well as effective overall group dynamics of the board, are as important to good governance as having appropriate structures and practices in place. Insurers place considerable emphasis on recruiting suitable board members from as large a pool as necessary to ensure board members are appropriately qualified to undertake their role. In addition, ongoing training of those who are appointed is good practice. See also the section on Functions of the board of directors below.

Independence

35. Board members are expected to exercise objective, independent judgement in the affairs of the insurer. The governance structure can, in addition to other possible measures (see Conflict of duty or interest and Qualifications of board members, below), serve to support independent decision making by the board and reduce the risk of conflicts of interest. Specifically, promoting the independence of certain elements of the governance structure may enhance the overall system of insurer governance.

36. Ensuring that there are a sufficient number of outside directors (ie, non-executive and independent of the insurer and of the group to which the insurer belongs or of controlling shareholders) on the board contributes to its independence. Recruiting a

sufficient number of appropriately qualified individuals, who are also independent, can be an issue in some cases. Outside directors are particularly important for board committees dealing with issues where conflicts of interest are most likely to arise (eg, financial and non-financial reporting, reviewing intra-group transactions, nominations of board members and senior management and remuneration).

37. In addition, the board may separate the positions of the chair of the board of directors and the chief executive officer, and undertake other measures to establish a clear separation of duties between the board and management.

38. Clear, specific criteria may also be developed to define more precisely an "outside" or independent director. Additionally, regulation may set out a definition of independence and requirements to promote independence within the governance structure; for instance, audit committees may be required to be composed entirely of outside board members. In the case of mutuals and cooperatives, merely being a policyholder does not prevent a board member from being independent.

39. A board renewal policy may help to ensure that the board remains open to new ideas and maintains independent thinking, while retaining adequate expertise.

Delegation of powers

40. Sound governance requires a board to clearly define its decision making processes and delegation of powers. The definition is sometimes found in legislation or the by-laws but more commonly in internal procedures. The delegation of powers defines the roles and responsibilities of each corporate body or function, including the control functions such as risk management, internal audit, compliance and others. It can also describe tasks delegated to committees of the board.

41. It should be noted that even if some duties are delegated, the board is still ultimately responsible for the success or failure of the insurer. Thus board members need to ensure that they have regular and robust interaction with management and with the control functions and recognise it is part of their duty to proactively request information and question and challenge this information when necessary.

Committees of the board

42. In many jurisdictions, the board may delegate some of its tasks to committees. By allowing a small group of board members to focus on and specialise in specific areas, board efficiency can increase. However, whether a board uses committees depends on many factors, including its size. Some jurisdictions may require the establishment of certain committees (eg an audit committee). Under most legal systems, the board retains ultimate responsibility for matters delegated to a committee, including the right to make the final decision. Thus committees often make recommendations which the full board must approve.

43. Members of board committees are normally drawn from the full board. The chair of the committee can be selected by the full board, by the chair of the board or by the committee members. In some jurisdictions, employees are also represented in board committees, although certain jurisdictions discourage this practice, as they believe it increases inefficiencies. Membership in some committees may be established *ex officio* under general board procedures. Nomination committees, where they exist, may carry

out the responsibility of nominating members to committees. In a few cases, the general assembly has a role in approving nominations to committees.

44. Board committees may include any of the following or any combination of the following:

- audit committee
- remuneration committee
- nominations committee
- ethics and/or compliance committee
- risk management committee
- investment committee
- disclosure committee
- governance committee
- human resource committee
- strategic development committee
- asset-liability management committee
- a committee focused on participating policies.

45. The survey results indicate that the establishment of an audit committee is generally seen by supervisors and insurers as being necessary for a sound and effective system of corporate governance. The responses also indicate that both supervisory expectations and industry practice regarding the establishment of board committees generally exceed regulatory requirements and that the establishment of committees beyond those legally mandated is seen as necessary to assist the board in ensuring effective oversight and to improve the efficiency of governance. Globalisation, increased cross-border insurer ownership, and a desire by insurers to meet market best practice were cited by insurers as the main reasons (besides new legal requirements) for the establishment of new committees.

46. The role and obligations of board committees are typically described in a committee mandate, which in some jurisdictions is made public (eg by posting it on the insurer's website). It is good practice for the board to review each mandate regularly. The survey results indicate that supervisors see the role of board committees as enhancing oversight of the insurer's governance and including, in some cases, specific supervisory sign-off or whistleblowing obligations. By contrast, industry responses emphasise the role of committees in ensuring a greater and closer review of management policies, supporting the overall work of the board, and dealing with specific mandates from the board to go into specified matters in greater detail. Industry responses also highlight the role of committees in enhancing the transparency of governance.

47. The committees the board establishes to promote effective governance depends on the size, nature, complexity and risk profile of the insurer, as well as local requirements and accepted practice. A description of some typical committees is found below. The list is not exclusive or ranked by priority.

Audit committee

48. Responsibilities of the audit committee may include:

- overseeing financial statements, financial reporting and disclosure processes
- monitoring accounting policies and practices
- overseeing the audit process (external and internal), including reviewing the auditor's plans and material findings
- overseeing hiring, removal, performance and independence of the external auditors, including prohibiting or regulating the provision by the external auditors of non-audit services to the insurer (in some jurisdictions the approval and removal of external auditors must be approved by shareholders)
- overseeing the hiring, removal, performance and independence of the internal audit function
- reviewing intra-group transactions
- if there is no separate committee for functions such as compliance, risk management, governance or internal controls:
    - oversight of governance, regulatory compliance, ethics and processes for the reporting of potential breaches or violations (including whistleblower hotlines, etc.)
    - oversight of risk management and internal control processes.

Remuneration committee

49. Responsibilities of the remuneration committee may include:

- proposing a remuneration approach and related policies for the insurer usually covering:
    - remuneration policy
    - remuneration governance and structure, including the approval policy for the level and composition of compensation
    - components of compensation, such as the amount of the fixed remuneration, shares or options, other variable remuneration, pension rights, redundancy pay and other forms of compensation and benefits, as well as the performance criteria and their application
- preparing a remuneration report or other required or voluntary disclosures on compensation practices
- reviewing and making recommendations regarding the specific remuneration of board members, the chief executive officer, members of senior management and sometimes of other high earners (even if they are not members of senior management). Increasingly the remuneration committee (or the audit committee) also approves or provides oversight for the compensation of control functions, such as the internal auditor
- ensuring that the remuneration approach is consistent with performance and the risk management framework of the insurer

Nominations committee

50. Responsibilities of the nominations committee may include:

- implementing the board's policy on board renewal so that the board individually and collectively continues to maintain target skill levels and independence
- making recommendations to the board with regard to the nomination for appointment or reappointment of members of the board consistent with appropriate criteria established in their profiles and any succession plan
- ensuring proper orientation of board members in respect of their responsibilities and completing job descriptions and responsibilities for each board member
- establishing a mechanism for the formal assessment of the effectiveness of the board as a whole as well as the contributions of individual members
- making recommendations to the board for dismissal and retirement of members of the board and senior management
- making recommendations to the board with respect to succession planning for the chief executive officer and other members of senior management and with respect to management development principles
- making recommendations to the board on nominations of members for board committees
- reviewing the management development status and succession plans for key positions, as well as general talent management of the insurer (also see the section, Board accountability for management, below)
- ensuring that all directors receive appropriate ongoing training as required for them to fulfil their role requirements.

Ethics and/or Compliance committee

51. Responsibilities of this type of committee (or, where ethics matters are dealt with separately from compliance, as separate committees) may include:

- monitoring the compliance function and the insurer's risk profile in respect of compliance with external laws and regulations and internal policies, including the insurer's code of ethics or conduct
- receiving reports on the above and on proactive compliance activities aimed at increasing the insurer's ability to meet its legal and ethical obligations (such as communications and training of the board, senior management and other employees on compliance), as well as reports on identified weaknesses, lapses, breaches or violations and the controls and other measures in place to help detect and address the same
- supervising and monitoring matters reported using the insurer's whistleblowing or other confidential mechanisms for employees and others to report ethical and compliance concerns or potential breaches or violations
- advising the board on the effect of the above on the insurer's conduct of business and helping the board set the correct "tone at the top" by communicating, or supporting the communication, throughout the insurer of the importance of ethics and compliance

- approving compliance programmes, reviewing their effectiveness on a regular basis and signing off on any material compliance issues or matters.

Groups and conglomerates[4]

52. The governance structure of an insurer will be influenced by whether or not it is a part of an insurance group or a larger financial conglomerate. Insurers that are a part of a financial group are likely to be subject to governance policies and practices that are established at the group level and implemented uniformly across the group. Insurers belonging to a group seek ways to maintain consistency in policies and practices across the entities in the group in order to reinforce consistent practices and controls across the group.

53. That said, the governance practices of insurers within a group may differ. For instance, different obligations may apply to board members of a specific insurer, including requirements for independent decision making and control of the insurer. Also, an insurer's board will need to consider the appropriateness of any group governance practices to the business and risk profile of the insurer. Thus, group practices may have to be interpreted differently or amended in light of circumstances (including applicable laws and regulation) specific to an insurer within a group. To the extent that a group manages itself other than on a legal entity basis, it still needs to ensure that it does so consistent with the governance obligations of each legal entity. Some insurers belonging to a group may not have globally uniform governance practices, reflecting either a desire for flexibility in governance practices or a possible matter of work in progress. Ultimately, the board of insurers belonging to a group remain responsible and accountable for the management of the insurer.

Mutuals and cooperatives

54. Corporate governance of mutual insurers, and also to a certain extent insurers organised as cooperatives, is different in some ways from that of stock company insurers. However, the overall concepts described in this paper apply to all insurers including mutual and cooperative insurers. Mutual insurers are collectively owned (or controlled) by their members; some mutuals may also enter into business with third parties that are not members of the mutual. Similarly, cooperative insurers are commonly owned by a large number of policyholders. Mutuals are not commonly managed with the prime objective of maximising profit.

55. With a mutual insurer having no external capital or shareholders in the traditional sense, each policyholder-member is *de facto* an owner in the mutual. In some insurance mutuals, policyholders participate in general meetings indirectly through member representatives.

56. In mutual insurers, the governance framework protects the rights of policyholder-members as owners. As noted in the OECD *Guidelines*, members of mutual insurers are able to:

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[4] See also IAIS *Principles on Group-Wide Supervision* (October 2008), and Annex 2.

- waive their interests in the mutual insurer by ending their insurance contract, subject to the terms and conditions of that contract
- participate and vote in general meetings, whether directly or indirectly (through a meeting of member representatives)
- obtain relevant information on the mutual insurer on a timely and regular basis
- typically elect members of the board
- approve proposals of the board in respect of rebates, supplementary contributions and the distribution of surplus earnings.

57. Effective policyholder participation in the governance structure of the mutual insurer requires both effective turnout and active participation at the general meetings of member policyholders or representatives. The voting system in place and the right of member policyholders or representatives to participate in general meetings varies.

Functions of the board of directors

Introduction

58. With the overall responsibility for the insurer, the board is legally obligated to conduct the insurer's affairs in the interests of the insurer as a whole. Increasingly, diffuse stock ownership and more sophisticated conglomerate and group structures have heightened the importance of effective governance and of the role of the board therein.

Source of board functions

59. Board functions arise from at least four sources:

- in general company law and insurance regulation, the jurisdiction of incorporation imposes statutory or rule-based requirements (possibly clarified by case law), including minimum requirements related to board composition and functions
- in common law jurisdictions, common law, or case law, can create certain expected board responsibilities, which can evolve over time (eg, in some jurisdictions, the "duty of care" has resulted in the expectation that a board must implement formal internal reporting structures)
- shareholders (or, in the case of mutuals, member-policyholders) can impose additional duties on the board that are enacted through by-laws, organisational rules or other insurer-specific documents
- market forces can lead to the adoption of evolving best practices, whether through self-regulation or on a voluntary basis.

60. In recent years, many jurisdictions have expanded specific board requirements, such as mandating an independent audit committee. The trend towards expanding requirements is related both to experience with corporate failures but also to the growing complexity and size of group structures and the convergence of best practices. Higher expectations can also arise when public monies are at stake, such as in the case of government support for the financial and other industries which further bolsters the need for effective oversight and board accountability.

Specific board responsibilities

Corporate governance

61. A primary board function is to articulate and commit to specific corporate governance principles. These principles shape the governance structure and practices of insurers. In some jurisdictions boards rely on these principles when deciding on fundamental governance issues – such as on what type of checks-and-balances to have in place. The board regularly oversees internal reviews and authorises external reviews of corporate governance principles, processes and outcomes. As an insurer grows and its risks evolve, it may have to clarify or revise its principles and strengthen its corporate governance practices.

Code of ethics and standards of business conduct

62. A key board function is to establish strategies and policies that define ethical individual and corporate behaviour and ongoing, effective processes that ensure adherence to these strategies and policies. The most effective, address a broad range of topics, are connected to the insurer's values and culture, and are communicated clearly by senior management throughout the organisation. Topics include:

- obligation to comply with law, regulations and the insurer's strategies and policies
- conflicts of interest
- decision making guidelines where it may be legally or ethically unclear what the right decisions should be
- channels for encouraging and facilitating employees raising concerns or reporting a possible breach of law or regulations, with appropriate measures to protect against retaliation against reporting employees
- fair treatment of policyholders and employees
- information sharing with stakeholders, including investors, policyholders, member-policyholders (for mutuals or mutual-type associations), employees, supervisors, and other consumer or rating agencies

63. A well governed insurer develops and nurtures a corporate culture that recognises and rewards adherence to ethical standards. The appropriate "tone at the top" helps prevent corporate misbehaviour and protects policyholder and investor interests. The survey results show that supervisors and insurers believe that ethical standards have an impact on the governance of insurers.

Conflicts of duty or interest

64. Responsible board members avoid positions where their interests and duties would conflict with duties they owe to the insurer. Board members disclose to the board in a timely manner any potential conflict of interest or apparent conflict of interest. This duty is normally set out in the insurer's by-laws or organisational rules along with a description of the process by which the board resolves potential conflicts. In some jurisdictions, conflicts of interest can also be connected with implicit fiduciary duties imposed by common law. Potential conflicts include situations where:

- a board member considers accepting a board position in another company
- an insurer enters into a transaction or makes an investment in other companies in which a board member or a relative may have financial or other interests
- an insurer hires a relative or other person with whom the board member has a close connection.

65. A further potential conflict for stockholder companies, is the competing interests of shareholders, policyholders and management. To help address this some jurisdictions impose a duty on the board to consider or act in the interests of policyholders or prospective policyholders, or issue non-binding guidance to this effect. In mutual (and to a certain extent in cooperative) insurers, conflict between policyholders and shareholders is not relevant as mutuals do not have shareholders and are owned/controlled by their policyholders.

66. Foreign-owned insurers that are wholly or majority owned can experience potential conflicts between the interests of the parent (and wider group) and the local insurer. While controlling shareholders can bring beneficial resources and expertise, it is important that such ownership structures do not impede sound local corporate governance. For instance, the local board may place too much reliance on the parent's risk management scrutiny, rather than exercising its own scrutiny. Where matrix management is practised by the parent (and wider group), it can promote accountability to the group but may limit senior management accountability to the local board.

67. Intra-group transactions and/or the existence of controlling shareholders may present challenging potential conflicts of interests for boards. The survey showed that supervisors consider these factors to be important in terms of their impact on the governance structure of insurers.

68. Possible actions to address potential conflicts of interest include board-level review of key transactions, public disclosure of conflicts of interest, specific regulatory requirements (including supervisory review) to manage and control these conflicts and proper internal policies and procedures. The general assembly of shareholders (or, in the case of mutuals, member-policyholders) might also have a role in terms of approvals or in terms of being informed.

Strategies and policies

69. Another important function of the board is to set and oversee the implementation of the insurer's strategies and policies. The written strategies and policies are subject to prior approval by the board. Thus the relevant strategies and policies are ideally approved before an insurer introduces new risks or products. They are reviewed at least annually and adapted in view of any significant change in the internal or external environment.

70. Key decision areas to be covered by strategies and policies normally include:

- strategic direction and marketplace positioning
- risk appetite (eg, insurance, credit, market, and other risks) and risk profile
- choice of insurance lines and other business activities and the introduction of new products, along with possible repercussions of new business propositions
- pricing, underwriting, provisioning and reinsurance cover
- investments and asset-liability management
- mergers, acquisitions and strategic alliances
- choice of corporate structure (eg, benefits and risks associated with de-mutualisation, going public or the creation of a holding company)
- outsourcing
- funding and financing strategies
- annual budget
- overall governance strategies and policies (including board renewal, risk management, internal controls, audit, actuarial, conflicts of interest and intra-group transactions and compliance)

- remuneration
- the assessment of overall solvency needs

71. Strategies and policies decided upon by the board may also address such areas as disclosures, outsourcing, business continuity planning, reputational risk, complaints and claims handling, and dividends and policy bonuses. Board committees can also play a role in monitoring and reviewing board policies, including their implementation.

72. Senior management is responsible for implementing and monitoring board strategies and policies within the insurers' operations and planning, conducting, and controlling the day-to-day activities of the insurer. Senior management has an important role to play in mapping the risks faced by the insurer and properly managing these risks, and developing ethical behaviours and professional conduct and leading "by example". Senior management promptly identifies issues and events and brings them to the attention of the board. In practice, senior management may also assist in the development of strategies and policies for review and approval by the board.

73. To evaluate and guide business strategy properly, a board establishes and monitors performance objectives for the insurer and for senior management. The board also reviews these performance objectives, and any related remuneration, to ensure that they are in line with the insurer's long-term interests.

74. Staff members are trained in the strategies, policies and procedures relevant for their areas of responsibility and instructed to take them into account in their daily work.

Internal reporting system

75. Effective board decision-making and monitoring of senior management depends upon the quality and timeliness of the information received by the board and its committees. The formal process by which the board receives regular information and analysis of the insurer and requests and receives additional information when necessary is known as the "internal reporting system." An informed board will have a reliable and comprehensive internal reporting system in place and makes effective use of it.. The board regularly evaluates the system and makes corrections as appropriate. These corrections are essential given that the board, no matter how independent, is in many ways dependent on the insurer's internal reporting system. It is the board's duty to request any information not provided in the insurer's internal reporting which it deems necessary to carry out its responsibilities. Externally generated reports, such as the report of the external auditor, provides important information for the board. The board may seek independent external advice to enhance its decision making and monitoring.

76. Well governed insurers develop internal reporting systems that include information on all risks to which the insurer is exposed at all levels, in an appropriate format. This may include such information at the group and parent company level and the level of other operating companies and subsidiaries. Internal reporting also includes reporting against strategies and policies. The board reviews this information on a regular basis. Senior management may attend meetings of the board or of board committees in order to provide further reporting. In addition, board members may seek direct access to management and staff.

77. The recent financial crisis has highlighted that the essential value of an internal reporting system depends not only on what is reported but also on the extent the board takes account of such information and understands it. It also depends, in large part, on the board's independence and willingness to use and challenge such information to

make its own independent judgements. A board is responsible for understanding and guiding strategy with respect to the risks of the insurer and the instruments used to manage or hedge against those risks.

Remuneration

78. It is good practice that board and employee remuneration policies are set and reviewed periodically to:

- reflect performance over an appropriate time horizon to avoid rewarding only for short-term results
- reflect individual performance, not just insurer performance
- encourage prudent behaviour consistent with the best interest of the insurer, shareholders and policyholders, and consistent with good governance (including in respect of risk management and compliance)
- comply with all applicable laws and regulations, also considering the remuneration best practice for the respective type of insurer
- allow the insurer to attract and retain qualified individuals
- conform with the insurer objectives, including adherence to the insurer's risk management policies.

79. Remuneration is one of the most important means an insurer uses to attract and retain competent board members and management. Remuneration can also be used to achieve alignment with the insurer's many interests. Tying compensation to the appropriate time horizon is particularly important for insurers because prospective liabilities may extend many years into the future. Increasingly companies are designing compensation packages that include equity stakes or ownership interests that encourage management not to take unacceptable risks in pursuit of short-term pay increases. To protect against unacceptable risk-taking, remuneration can be connected not only to financial performance but also to the efficacy of governance and risk management and to the compliance by the insurer and its managers with legal and ethical obligations. Given the importance of remuneration, an increasing number of jurisdictions are examining how to address the subject in regulation and supervision.

Fitness and propriety of board members

80. In many jurisdictions, board members are required to meet fit and proper criteria [5] meaning that they are expected to act with integrity (propriety) and have the professional qualifications, knowledge and experience necessary to assess the risks to which the insurer is exposed and to assess the suitability and effectiveness of the risk management system.

81. The survey responses highlight the importance of fit and proper requirements. Supervisors saw fit and proper board members and management as the key basis for

[5] See also IAIS *Supervisory Standard on Fit and Proper Requirements and Assessment for Insurers* (October 2005), and Annex 2.

high quality corporate governance, ahead of board independence, sound regulation on governance, transparency and disclosure and well-functioning risk management systems. This may explain why supervisors have imposed specific fit and proper rules to protect policyholders. Meeting “fit and proper” requirements is not a single event, but an ongoing duty that requires continuous board education and training. Compliance with these rules is a board function that is critical to the long-term interests of the insurer.

82. Significant owners or controlling shareholders are sometimes given the right by contract or otherwise to serve, or to nominate someone to serve, on the board of directors. Such persons are still subject to fit and proper criteria in terms of integrity and of qualifications.

83. The board, through the nomination committee or some other review mechanism, assesses the adequacy of the mix of skills and expertise on the board and recommends actions to fill any gaps that are identified. Whilst it is important that each individual member meets the requirements of his role, it is not necessary that each has a complete and homogeneous set of skills and knowledge as it is the collective skill of the board that determines its effectiveness.

84. Boards may engage in self-evaluation, both for the board as a whole and for individual board members. This allows the board to monitor how well the board and each board member performs. Some boards engage external parties to help in conducting these evaluations.

85. Targeted board training is critical for insurers. Boards with proper expertise and knowledge are generally more capable of overseeing management and exercising greater independence in the process.

86. The time commitment necessary to fulfil the duties and obligations of board members is an important consideration. Limiting the number of directorships a board member can hold may be beneficial in this respect.

Accountability

Board oversight of management

87. Senior management is accountable to the board. The two primary tools of this accountability are:

- organisational and governance strategies and policies (informed by by-laws and legislation)
- established performance objectives relating both to agreed strategies and policies and to strategies and policies involving governance, including efficient risk management.

These tools are updated by the board as the business of the insurer evolves and as market conditions and corporate best practices change. Senior management provides regular reporting to the board on implementation of board strategies and policies and on progress made against performance objectives set by the board. Board control over remuneration provides an instrument for reinforcing senior management accountability.

88. Boards are responsible for oversight of staff with operational responsibilities, including the chief executive officer, other members of the senior management or equivalent and other key positions. For senior management, this oversight responsibility includes:

- setting appointment and dismissal procedures
- ensuring appropriate qualifications
- monitoring performance
- initiating and overseeing necessary investigations of management and, when appropriate, seeking advice from outside experts
- providing appropriate compensation.

Board responsibility for oversight and on-going monitoring also extends to third parties hired to perform functions that impact governance, as well as outsourced activities and functions.

89. By holding senior management accountable for results, the board reinforces its separation from and authority over management. The boards' authority can also be reinforced by:

- ensuring that the board can meet without management's presence
- ensuring that staff or external parties involved in key control functions can meet with the board without management's presence
- appointing an independent "lead board member" who can provide leadership when it is not possible or appropriate for the chief executive officer or chairman to lead in an insurer where the chief executive officer also chairs the board (a practice prohibited or discouraged in many jurisdictions). In some jurisdictions, a lead board member may also call and preside over board meetings and consult and communicate with stakeholders.

90. The board's ability to properly oversee senior management, and the insurer in general can be diminished by many factors, such as:

- strong-willed senior management who are not appropriately controlled
- a chairman who does not possess sufficient authority
- a dominant chairman who fails to facilitate and accept independent views from other members
- members who do not spend the time necessary to fulfil their duties (eg fail to attend, leave early and/or insufficiently prepare for meetings)
- members who are reluctant to challenge management or hold it accountable or merely rubber stamp management's recommendations
- members lacking necessary skills or knowledge
- lack of access to adequate resources to perform its functions.

Identifying these factors and mitigating their effects is key to the proper functioning of the board.

Board accountability to others

91. The board is ultimately accountable to a potentially wide range of stakeholders – shareholders, policyholders, members, supervisors and the marketplace. The boundaries of board accountability depend on the nature of the insurer (eg publicly listed) and may vary by jurisdiction. The board are, at a minimum, accountable to

shareholders (or member-policyholders in the case of mutuals and cooperatives), who are responsible for the appointment and removal of directors. The meeting of shareholders (or member-policyholders or their delegates in the case of mutuals and cooperatives) thus provides a forum for reporting on and discussing the performance of the insurer and its board. Shareholders (or member-policyholders) can sanction board members by dismissing them or deciding not to reappoint them to the board. Board accountability can also be strengthened by effective documentation of decisions of the board and its committees

92. Recent government aid to insurers is altering and will continue to alter the way and extent to which governments and supervisors hold boards accountable. Some governments have taken direct ownership stakes or provided aid or low-interest financing only after the insurer agreed to certain conditions (eg limits on management compensation, penalties for default or late payment, improving governance practices).

93. Generally, a board member owes a duty of care to policyholders, shareholders and the insurer as a whole. The extent to which a jurisdiction provides for legal liability of board members and senior management may influence how a board and management approach their tasks. In many jurisdictions, however, a board member may avoid liability for decisions made using reasonable business judgement. But the threat of litigation and potential liability can still influence the behaviour of board members. To counterbalance this threat, some insurers indemnify or insure board members against certain liabilities.

94. Most boards also use other mechanisms to promote their accountability. These mechanisms include board self-evaluations, the use of the nomination committee to give in depth attention to specific matters as well as timely and accurate public disclosure (eg, on material changes in investment performance, changes in the solvency position and changes in senior management).

Control functions

Introduction

95. The control functions encompass the individual insurer as well as the entire corporate structure (ie, the needs and obligations of any subsidiaries or affiliates are considered by the parent company when they take on risk)[6].

96. It is essential that an insurer understands its risks and obligations. This includes having a thorough understanding of:

- sources of risk, risk types, characteristics, inter-relationships and potential impact on the business
- laws and regulations that apply to the insurer and to the individuals involved in the insurer.

97. Thus it is important that the insurer has in place:

- robust and efficient mechanisms for the identification, assessment, quantification, control, mitigation and monitoring of the risks
- suitable strategies, policies and procedures for ensuring compliance with internal strategies and policies, and applicable laws and regulations
- appropriate internal controls to ensure that the risk management and compliance policies are observed
- an internal audit function capable of reviewing and assessing the adequacy and effectiveness of, and the insurer's adherence to its internal controls as well as reporting on its strategies, policies and procedures.

98. The control functions of an insurer are staffed by persons possessing the appropriate integrity, competence, experience and qualifications. These persons are able, where appropriate, to demonstrate relevant experience and expertise, meeting any applicable professional and other standards. The insurer is responsible for ensuring that staff meets fit and proper criteria initially and on an ongoing basis.

99. Independence of the insurer's control functions, including the risk management and internal audit functions, from business operations is important. Independence, and the dissent and alternative perspectives it may generate, can help insurers formulate responsible control and risk management strategies and policies[7].

100. The independence of control functions can be promoted by a number of mechanisms. The survey results highlighted the importance of the independence of control functions and of the actuary and external auditor. The results suggest that direct reporting to, and oversight by, the board or the supervisor (possibly also to shareholders or member-policyholders at the annual general meeting) are considered to be among the

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[6] This paper uses the terminology "risk management system" while other IAIS papers use the term "ERM framework". No substantial difference between the concepts is intended

[7] This paper mentions "written strategies and policies". In other IAIS documents these strategies and policies are described as "risk management policy and risk tolerance statement"

most effective ways to promote the independence of control functions. Access to the external auditor is also seen as very important, especially for the internal audit and compliance functions (a point highlighted by insurers). Supervisory respondents emphasised the importance of participation of staff responsible for these functions in meetings of the board. The results suggest that other measures, such as the existence of independent performance evaluations and independence of control function personnel are of value.

101. Supervisors may promote the independence of control functions by requiring certain control functions (e.g., internal audit) to be independent by law, requiring the establishment of clearly documented definitions and segregation of roles and responsibilities, establishing supervisory overview and external auditor review of internal controls, requiring supervisory assessment of fit and proper evaluations (involving ex ante supervisory approval of individuals prior to their appointment to the board or an ex post approval, ie, once the appointment has been made), and requiring the establishment of an independent compliance function with competent staffing.

102. It is important for the supervisory authority to have access to any information needed to assess the control functions of each insurer under its jurisdiction and to monitor any specific risk management, control or internal audit issues. Such assessments are carried out periodically and in a systematic way.

103. In some jurisdictions the insurer notifies the supervisor of:

- appointments and changes of key control functionaries and the rationale for the change/resignation/retirement
- information relevant to assess their fitness and propriety
- replacements due to a key control functionary no longer fulfilling the fit and proper criteria.

104. Where necessary supervisors exchange information relevant for the fit and proper assessment of the key control functionaries with other supervisors or authorities inside and outside its jurisdiction.

105. For insurers within a group, appropriate and effective group-wide risk control systems are needed in addition to the control systems at entity level. Supervisors need to be able to establish, with a reasonable level of assurance, that risks are being managed appropriately on a group-wide basis as well as at the legal entity level.

106. If insurers outsource a control function partly or in full, the board still exercises its oversight duties in respect of that function and sets clear requirements on what information shall be reported to the board. Ultimate responsibility for the function remains with the board.

Risk management[8]

107. A robust risk management system is an integral element of a sound governance system. The risk management process helps the insurer understand the nature and significance of the risks to which it is or may be exposed and manage them accordingly. The establishment of a risk management function is required in many jurisdictions or is encouraged by supervisors.

108. Risk management systems are made up of strategies, processes and reporting procedures that identify, assess, quantify, control, mitigate and monitor the risks. They operate on a continuous basis and at an individual and aggregated level. Risk management systems recognise the interdependencies of risks and take into account the nature, scale and complexity of the business of the insurer.

109. Insurers ensure that their risk management system is well integrated into their organisational structure, decision making processes and corporate culture and that there is a clear link to other functions such as asset-liability management. Insurers establish, and operate within, a sound Enterprise Risk Management (ERM) framework as part of their overall governance structure, appropriate to the nature, scale and complexity of its business and risks. This framework is integrated with the insurer's business operation and culture and addresses all reasonably foreseeable and relevant material risks faced by the insurer[9]. In this context it is acknowledged that the broad aspects of governance, such as an effective internal control system and a prudent remuneration policy are important preconditions of effective risk management.

110. The board is responsible for ensuring that the risk management system is suitable, effective and proportionate for the business of the insurer and that it is implemented and monitored[10]. This includes a regular review of the strategies and policies with regard to risk management. As the current financial crisis demonstrates, risk management is key to the board's broader governance responsibility to develop and oversee the insurer's overall business strategy.

111. An insurer has a risk management policy which outlines the way in which the insurer manages relevant categories of risk, both strategically and operationally. The insurer's risk management policy includes the objectives, key principles and assignment of responsibilities across all its activities. The risk management policy is consistent with the insurer's overall business strategies and policies and is set out in the insurers' written strategies and policies approved by the board.

112. Risk management systems address all reasonably foreseeable and relevant risks included in the calculation of any capital requirement(s) as well as the risks which are

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[8] Whereas this paper generally discusses risk management in a governance context, IAIS papers on enterprise risk management for capital adequacy and solvency purposes provides standards and guidance on risk management from a capital adequacy and solvency perspective; see *Standard on enterprise risk management for capital adequacy and solvency purposes* (October 2008) and *Guidance paper on enterprise risk management for capital adequacy and solvency purposes* (October 2008), and Annex 2.

[9] See also IAIS *Standard on enterprise risk management for capital adequacy and solvency purposes* (October 2008), requirement 1, and Annex 2

[10] See also IAIS *Standard on enterprise risk management for capital adequacy and solvency purposes* (October 2008) requirement 3 which reads "the establishment and operation of the ERM framework should be led and overseen by the insurer's board and senior management", and Annex 2.

not, or not fully, included in that calculation. The systems cover all relevant categories of risks – including as a minimum underwriting and provisioning risk, market risk, credit risk, operational risk and liquidity risk. In addition, some of the current risk management practices cover at least the following items:

- complex instruments, in particular derivatives and similar commitments[11]
- reinsurance and other risk mitigation techniques
- business and reputation risk
- group contagion risk (if relevant)
- legal and strategic risk

113. It is important that the board and management seeks and receives all information necessary to assess the risks to which the insurer is exposed and determines suitability and effectiveness of the risk management system.

Risk management function[12] and risk management committee

114. A risk management function is charged with implementing the relevant board strategies and policies. While embedded in the organisational structure and with defined reporting lines, the risk management function normally has direct access to the board. This ensures that the function is objective and independent from operational functions. The risk management function may be headed by a chief risk officer.

115. The risk management function:

- may consist of several sub-functions, eg, for different risk categories. Where this is the case, it is necessary to ensure that these sub-functions report to one common point that aggregates and challenges the reports and is able to form an overall view of the risk management system
- can be combined with other control functions as long as its independence from business functions and integrity of other control functions is ensured via additional control procedures, no conflicts of interest arise and it is still able to exercise its checks-and-balances role
- has a right to obtain any information relevant for the performance of its tasks.

116. The survey results indicate that, for most industry respondents, the risk management function is centralised or there are plans underway to centralise this function[13]. Cost, independence, and limited available expertise were cited as the main

[11] Similar commitments refer to financial instruments whose attendant risks are sometimes difficult to determine and whose proper management requires specific expertise

[12] A function is an administrative capacity to undertake a particular task. The identification of a particular function does not prevent the insurer from freely deciding how to organise this function in practice unless this is otherwise specified.

[13] Survey respondents may have used different definitions of the concept "centralised". Centralised may have been used to mean centralised across a group or conglomerate or centralised within an insurer.

reasons for the decision to centralise the risk management function, though some insurers adopted a centralised approach to achieve consistency with shareholder or board views as to what would constitute good practice. The small minority of insurer respondents adopting a decentralised approach indicated that it provided greater responsiveness to business needs.

117. The method of determining the remuneration of the risk management staff need to be structured so as to not compromise their objectivity.

118. The tasks of the risk management function include:

- assisting the board in the effective operation of the risk management system by performing specialist analyses and quality reviews
- maintaining a group-wide and aggregated view on the risk profile of the insurer in addition to the solo and individual risk view
- reporting to the board details on the risk exposures and the actions that have been taken (or should be taken) to manage the exposures
- advising the board with regard to risk management decisions in relation to strategic and operational maters such as corporate strategy, mergers and acquisitions and major projects and investments.

119. The risk management function at insurers has evolved in recent years. The survey responses indicate that, for insurers, general business demands, the need for increased transparency and the contribution of foreign shareholders and group membership have been key drivers in the development of the risk management function. Supervisors consider that new regulatory requirements have provided a significant impetus for change.

120. The survey responses address the question of impediments to the effectiveness of sound risk management. The main identified impediments include inadequate data, challenges posed by technology, cultural issues and inadequate staff training. Some insurers identified the recent turmoil as posing a challenge to the effective implementation of risk management processes.

121. The survey revealed that many jurisdictions impose special requirements for internal controls and risk management policies in respect of policyholder funds and accounts for participating life insurance and unit-linked business.

122. Some boards establish a risk management committee (see also the section *Committees of the board of directors)*. The risk management function and risk management committee need the necessary authority, resources and access to all relevant information. In addition or as an alternative, some insurers establish a risk management committee at the management level. Such a committee can assist in coordinating the risk management approach within the insurer and help strengthen management involvement in the risk management process. It can also help in focusing the information that requires board attention. However, a risk management committee is not a substitute for board attention and action in respect of risk management matters.

Internal models[14]

123. In some jurisdictions the supervisor may require insurers to use a prescribed model for regulatory purposes. In other jurisdictions an insurer may have the choice of whether to use a prescribed model or its own internal model, full or partial. The insurer's board and senior management require overall control of and responsibility for the construction and use of the internal model. A model can help the insurer to obtain a comprehensive and quantitative view of risks and make specific calculations on solvency and related matters. When this is the case, the insurer needs adequate resources and structures to ensure that the internal model is well managed and is, and stays, appropriate for its risk profile.

124. For insurers using a partial or full internal model, the risk management function typically perform the following tasks:

- designing and implementing the internal model
- testing and validating the internal model
- documenting the internal model and any subsequent changes
- informing the board and senior management about the performance of the internal model, suggesting limitations of the risk management framework and the potential impact in practice of these limitations on risk management and updating them on the status of efforts to improve previously identified weaknesses
- analysing the performance of the internal model and producing summary reports
- maintaining contact with the supervisor about the model, if necessary and appropriate.

125. In this context, the risk management function is responsible for integrating the internal model into the overall risk management system and day-to-day functions of the insurer. It assesses the internal model as a tool of risk management and as a tool to calculate the insurer's capital requirements.

126. Reports on the performance of the internal model are tailored to the requirements of the board, enabling its members to understand all relevant facts and their implications. The reports serve as one of the sources of information for board and management decisions.

Stress tests[15]

127. The recent financial crisis has demonstrated that it is good practice to perform stress tests in respect of risks and solvency as well as capital requirements, and to ensure that adequately severe stress parameters are considered. This may include the performance of stress tests to assess the insurer’s ability to cope with a variety of

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14 See also IAIS *Standard on the use of Internal Models for regulatory capital purposes* (October 2008) and IAIS *Guidance paper on the use of Internal Models for regulatory capital purposes* (October 2008), and Annex 2.

15 See also IAIS *Standard on the structure of regulatory capital requirements* (October 2008) and IAIS *Guidance paper on the structure of regulatory requirements* (October 2008), and Annex 2.

possible future events, such as a change in economic conditions that could have unfavourable effects on their overall financial standing. The participation and advice of experts such as the actuary in stress tests may be desirable. In some jurisdictions stress tests are required. Board involvement in stress testing, including interpretation of the results and appropriate follow-up action, is good practice.

Contingency plans – business continuity

128. Insurers analyse their ability to continue business operations, as well as the long term risk management and financial resources required to do so. To this end insurers employ appropriate and proportionate systems, resources and procedures[16].

129. Typically contingency plans are developed for risks to which the insurer believes it may be exposed. For example, an insurer may develop contingency plans for scenarios where a natural catastrophe, a terrorist attack, a fire, a failure of the IT-system, a pandemic or the death or disability of key members of management was to occur.

130. A continuity management approach and each contingency plan are communicated to the relevant staff and training provided. The plans are tested regularly and updated to maximise relevance and effectiveness.

Asset-liability management (ALM)[17]

131. Asset-liability management (ALM) is the practice of managing a business so that decisions and actions taken with respect to assets and liabilities are coordinated, reflecting the exposure to the risk associated with the variation of their economic values. In order to ensure this is done properly, the insurer typically develops an ALM strategy under its ALM framework. Also, many insurers set up an ALM committee at board or management level to monitor the management of assets and liabilities.

132. Most insurers have written ALM policies to set out the obligations of those involved in the ALM process. These procedures are tailored to the needs of different product lines and combine them in order to optimise the overall ALM management. When introducing new products, insurers need to consider their ALM effect carefully.

The use of rating agencies in risk management

133. Rating agencies often evaluate corporate governance structures for the benefit of investors. With increased focus on corporate governance, some supervisors are evaluating the influence of rating agencies on board decisions.

134. The Joint Forum's report[18], *Stocktaking on the use of credit ratings* describes a wide spectrum in use of credit ratings by financial institutions. Despite some general differences, there are some notable similarities. The insurance sector, for example, commonly uses credit ratings for:

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16 See also IAIS *Standard on enterprise risk management for capital adequacy and solvency purposes* (October 2008), Requirement 17, and Annex 2.

17 See also IAIS *Standard on Asset-Liability Management* (October 2006), and Annex 2.

18 Available at [a reference will be added when the report is published in mid March 2009]

- determining capital requirements
- identifying or classifying assets, usually in the context of eligible investments or permissible asset concentrations
- providing a credible evaluation of the credit risk associated with assets purchased as part of a securitisation offering or a bond covering.

135. A number of commentators have noted that the financial crisis revealed weaknesses in, among other areas, the credit rating agencies' assessments of innovative structured products. They found that ratings failed to reflect worsening market conditions in a timely manner. As financial innovation increases, similar problems may occur particularly in areas where credit rating agencies have limited or no experience.

136. Lack of supervision and enforcement accentuated the problems. In many jurisdictions, there is a debate on whether credit rating agencies should be subject to supervision. The shortcomings are made worse by other issues like the so called "notching practice" and the question of over-reliance on ratings by investors.

137. Such over-reliance on third party assessments such as credit ratings can be avoided if the board ensures that the insurer conducts its own assessment and does not make investment or other decisions or base their risk management solely on credit ratings.

Internal audit

Internal audit function

138. Internal audit provides reasonable assurance to the board on the extent of adherence to, and the adequacy and effectiveness of, internal controls, policies, processes and reporting procedures. The survey results indicate that both insurers and supervisors believe that measures should be in place to promote the independence of the internal audit function.

139. The internal audit function may be staffed in-house. In some jurisdictions it may be outsourced to a third party service provider, although some jurisdictions require approval of such outsourcing. Any outsourcing of the internal audit function is carefully monitored. To be effective, the internal audit function requires adequate resources and competent and well-trained staff.

140. The tasks of the internal audit function may include:

- establishing, implementing and maintaining a risk-based audit plan to examine and evaluate the adequacy and effectiveness of the insurer's systems, internal controls, processes and reporting procedures and compliance by all units of the insurer and all staff. The internal audit plan is in many cases submitted to the board for approval
- ensuring that all material areas of activity of the insurer are audited over a reasonable period of time
- issuing findings and recommendations based on the results of work it has carried out and verifying compliance with these findings and recommendations.

The survey report shows that direct reporting of significant internal audit findings and recommendations to the board is an important means of ensuring independence of the internal audit function. At a minimum, the internal audit function reports any major shortcomings with regard to the compliance with strategies, policies, internal procedures as well as external obligations. It also informs the board on the adequacy of the insurer's risk management, compliance and other control functions and the internal control systems. Internal audit makes recommendations on how to remedy inadequacies and reports on the extent management has implemented past audit recommendations. The board determines what actions to take with respect to each finding and recommendation and ensures that appropriate actions are carried out.

Access and independence

141. The internal audit function and audit committee need to have a complete and unrestricted right to obtain any information relevant for the performance of its tasks. This includes the prompt provision of all necessary information, the availability of all essential documentation and the ability to look into all activities and processes of the insurer relevant for the discharge of its responsibilities. They can communicate directly with any member of the insurers' staff.

142. The internal audit function and audit committee establish their audit plans and carry out their assignments objectively and independently from the operational functions and activities of the insurer. In some jurisdictions, to ensure independence, insurers are not allowed to combine the internal audit function with other functions. ..

Written policies

143. Most insurers have written policies on internal audit which contributes to its efficient operations and supports the internal control framework. Policies cover at least:

- objectives and scope of the internal audit function and audit committee
- their status within the insurer and reporting lines
- competences and responsibilities of staff in the internal audit function or members of the audit committee.

144. The written policies are subject to prior approval by the board and are subsequently reviewed at least annually.

Compliance

145. To ensure compliance with its obligations under applicable laws and regulations and to promote an ethical corporate culture, a well governed insurer:

- has a compliance function in place with appropriate expertise, resources, authority, and independence
- establishes, implements and maintains appropriate strategies, policies, procedures and training programs. These efforts cover all employees and the insurer as a whole, as well as to the board of directors with appropriate adjustments.

146. The compliance activities of an insurer are designed not only to minimise any compliance failures or lapses but also to enhance the insurer's overall ability to make sound decisions, consistent with the insurer's legal obligations and ethical values. These activities also contribute to a better relationship with the supervisor and can help reduce the insurer's overall legal risk.

Compliance function and compliance committee

147. The tasks of the compliance function may include:

- identifying and understanding laws and regulations that may apply to the insurer and changes that may have an impact on the operations of the insurer
- conducting compliance risk analyses
- preparing for board approval a code of conduct and managing the implementation of and compliance with the code
- preparing compliance policies, procedures, and controls, and administering them
- devising communications, training, and other strategies to increase sensitivity to the importance of compliance and ethics, as well as employee awareness of and competence in specific areas of legal and supervisory obligation
- putting in place mechanisms to encourage and facilitate employee reporting of compliance concerns or potential violations; these mechanisms are accompanied by a policy of non-retaliation against employees who report in good faith
- designing ways to help detect, investigate and address any compliance deficiencies or violations and assisting employees in respect of specific obligations under applicable laws, regulations and internal procedures
- regularly reviewing the adequacy of the compliance system and overall compliance efforts
- regular reporting to the board in respect of progress on all of the above, as well as on specific compliance issues or violations.

148. In order to enable the compliance function to discharge its responsibilities properly, the board may ensure that:

- the compliance function has the authority to examine any issue or potential violation at its own initiative, as well as to devise appropriate means to prevent and address them
- where appropriate, a senior level chief compliance officer is appointed and is responsible for the compliance function. In a group, the compliance function has officers who cover group-wide obligations and those who cover obligations at solo levels; the compliance function thus has the capability to have a group-wide and a solo perspective on compliance obligations and risks and to keep the board appropriately informed
- where necessary (such as in small companies) the compliance function may be combined with other appropriate functions, as long as its independence from the business functions is ensured via additional control procedures, no conflicts of interest arise and it is still able to exercise its checks and balances role
- the method of determining the remuneration of the compliance staff does not compromise their objectivity.

149. The board may choose to establish a compliance committee. The responsibilities of the compliance committee are set out above under Governance Structures and include overseeing the compliance function, reporting to the board on compliance

issues, monitoring whistleblowing activities and communicating the importance of compliance to members of the board and staff.

150. Where the insurer establishes a compliance committee, that committee is objective and independent and has the necessary authority to access all relevant information.

Reporting/whistleblowing mechanisms

151. In many jurisdictions, an employee of an insurer may report irregularities to the insurer's supervisor or an insurance professional association. But in addition to these channels, many insurers have mechanisms by which employees may, in confidence and in some cases also anonymously, raise concerns internally (for instance to the board or one of its committees) about possible irregularities, governance weaknesses, financial reporting issues or other such matters. A best practice is to ensure that the mechanism is not just limited to the reporting of actual violations but also encourages the early raising of concerns.

152. The mechanisms, often known as "whistleblowing", are sometimes in the form of a confidential phone number or address to which such reports may be made. In some cases an external provider manages the process. In other cases it is done within the insurer with appropriate safeguards to protect confidentiality. In some jurisdictions and insurers, such employee reporting goes directly to the chairman of the board or of a committee of the board or to the external auditor.

153. Whatever arrangements are in place, it is important that:

- they be well communicated to employees so they know that such channels are available, how to use them and how their report will be handled
- the reports received are handled confidentially, assessed independently, investigated properly as needed and where necessary appropriate follow-up actions are taken
- a robust anti-retaliation policy is in place protecting employees who make reports in good faith
- material matters raised in such reports are communicated to the board of directors.

154. Typically it is the compliance or internal audit function that manages the reporting/whistleblowing processes. The compliance function also prepares analyses for the board on trends of such employee reporting and informs the board of any instance of an employee being disadvantaged or retaliated against for having reported a matter.

155. Some jurisdictions protect whistle-blowers from retaliation or prosecution. This qualified privilege is designed to ensure that the whistle-blower provides full and frank information to the supervisor without fear of adverse consequences

156. Often the actuary and/or the auditor has the duty to report in a timely manner to the supervisor if he or she is aware that the insurer has failed to take appropriate steps to rectify a matter which has a material adverse effect on its financial condition. This allows supervisors to take prompt action before policyholders' interests are undermined. In some jurisdictions, before making such reports he or she must first report the matter to the board; in addition there may also be requirements for such reports to be provided to shareholders (or member-policyholders). The insurer may be required (by law) to provide all necessary information to the appointed actuary to enable the actuary to carry out this

whistleblowing role. The existence of such obligations may both increase the confidence of the supervisor in the compliance of the insurer and provide a direct link between supervisors and actuaries.

Actuary

Role of the actuary[19]

157. Actuaries have specific roles and functions which typically involve the calculation of an insurer's insurance premiums and risks, including technical provisions. Their roles and responsibilities differ from jurisdiction to jurisdiction. In some jurisdictions, an appointed actuary has to be formally designated by the insurers and approved by supervisors. Such appointed actuaries usually have a legal obligation to the supervisors to ensure that the interests of policyholders are protected. In addition to this, they may also provide professional advice to the board with regard to certain areas of risk management.

158. In some jurisdictions the insurer is required to appoint an actuary for participation contracts.

Qualifications of actuaries

159. In many jurisdictions supervisors require actuaries to meet minimum requirements. For example, they must have a minimum number of years of working experience in actuarial functions and/or posses certain professional qualifications. To this end, many insurers and supervisors require the actuary to be a fellow or member of a recognised association. Membership of an association recognised by the International Actuarial Association (IAA) means that the actuary is required to comply at all times with a strong ethical code of conduct, which is supported by potential sanctions, in addition to meeting the minimum requirements on skills and experience. In some jurisdictions insurers are required to disclose the qualifications of their actuaries showing that they have knowledge and experience that is commensurate with the nature, scale and complexity of the insurers' business.

Access to information

160. To evaluate the pricing and policyholder dividend distribution, as well as investment and reinsurance strategies, the actuary needs access to information about the insurer's overall strategy and policies, products and activities. Accordingly, the actuary needs to be:

- allowed access to the board and to relevant board meetings and meetings of board committees as well as meetings of senior management and of operational units
- allocated a budget to engage external parties for professional assistance where necessary
- granted the power to interview staff in divisions that produce work relevant to the appointed actuaries' functions.

[19] See also IAIS *The Use of Actuaries as Part of a Supervisory Model* (October 2003), and Annex 2.

Adequate frameworks and procedures

161. Insurers have policies and procedures for developing and pricing their products. The actuary ensures that premiums and provisions are calculated based on appropriate actuarial assumptions, so that they are sufficient to ensure the obligations resulting from the insurance contracts can be met. Furthermore, the actuary reports risks identified in line with the internal risk management framework.

162. The actuary estimates and recommends the amount of policyholder dividends to be allocated to participating policyholders, taking into account such factors as the need to ensure fairness and equity among different cohorts of policyholders and the future financial condition of the participating fund.

Independence of actuaries

163. The actuary plays a key role in an insurer by providing a check on the reliability and adequacy of the calculation of technical provisions and capital adequacy. The actuary acts independently, free from management interference. Because of the statutory or fiduciary obligations that underpin such independence, the actuary would not alter an opinion simply to improve the insurer's financial results or for any other purpose not consistent with his duties of objectivity.

Conflicts of interest

164. In some jurisdictions, actuaries cannot concurrently hold other positions in the insurer. For example, the functional actuary cannot also be the chief executive officer or the chief financial officer or work in operational activities such as sales, marketing or merger and acquisition. A dual or multiple role may put the actuaries in a conflicts of interest situation. For instance, a chief executive officer may focus on maximising the shareholder interests which might conflict with ensuring that the policyholder dividends are appropriate (an objective of the actuary).

165. In some jurisdictions, the actuary is also an employee of the insurer ("in-house actuary"), while in other jurisdictions, outsourcing to a third party actuarial firm may be used. There are pros and cons to each approach. For instance, there is a perception that in-house actuaries are beholden to management (eg, his or her opinions may not carry weight with management), notwithstanding supervisory frameworks that are put in place to ensure the independence. On the other hand, an in-house actuary may understand the business models and risks better than third party actuarial firms and may be more informed of what happens in the insurer. As such, they may be able to identify important issues more effectively. If outsourcing is used, the board also reviews if the external actuary has any potential conflicts of interest, such as if his or her firm also provides other non-actuarial services to the insurer. The board satisfies itself that any such potential conflicts are subject to appropriate controls.

Reporting lines

166. To provide professional advice and ensure that board members have sufficient understanding and information about the actuaries' opinions, many jurisdictions require that they have direct access to board members. There are variety of practices of the reporting lines between actuaries and board members. In some insurers, actuaries have a reporting line to the chief executive officer.

Role of the board and the actuary

167. There are differing views on whether the board should assume responsibility for decisions involving actuarial advice or certification, or whether they should be able to rely on the advice and valuations of the actuary. Some jurisdictions have assigned to the board responsibility for all key issues relating to the operation of the insurer, including actuarial matters such as the valuation of technical provisions.

Performance measurement, appraisal and dismissal

168. In many jurisdictions the performance evaluation of an actuary is done at board level, commonly by the audit committee made up mainly of independent board members. It is possible that a separate actuary may be appointed by the board to conduct a peer review of the actuarially assessed liability valuation report. Some jurisdictions require dismissal of actuaries to be publicly disclosed or reported to the supervisors. Some supervisors have the power to direct the insurer to remove an unsatisfactory appointee from the position.

Budget

169. Usually the board approves the budget of the actuary. Budgets for actuaries may be decided by the audit committee in consultation with the insurers' internal auditors and not solely fixed by management.

External auditor

Role of the external auditor

170. The financial statements of an insurer, which may include amounts determined by an actuary, are the responsibility of the board. An important role of an external auditor is to express an opinion as to whether the financial statements have been prepared in accordance with the applicable financial reporting framework and represents a true and fair view. Since the external auditor is independent of the board and management, this opinion helps to establish the credibility of the financial statements so that they may be relied upon by supervisors, as well as other stakeholders such as shareholders, policyholders, rating agencies and tax authorities. In some jurisdictions, the external auditor responsibilities may extend to providing assurance on other reports or disclosures, such as a special report to supervisors, (eg supplementary financial information submitted to the supervisor, or a report on the insurer's implementation of risk management and internal control systems).

171. The involvement of actuarial and other functions in the preparation of an insurer's financial statements does not lessen the responsibility of the board to produce reliable financial statements or the responsibility of the external auditor to express an opinion on such financial statements. In auditing the financial statements of an insurer, the external auditor must address the technical provisions established by the actuary, in particular to ascertain that they are based on reliable data and calculated using acceptable methodology.

172. Because the calculation of these provisions generally requires special expertise, methods and techniques, some auditing firms employ actuaries; alternatively the external auditor may engage an outside actuary. Independent actuarial advice enables the auditor to reach an informed conclusion regarding the appropriateness of the insurer's provisions. This type of advice is different from the reports that the actuary appointed by the insurer is required to produce.

173. The roles of the actuary and the external auditor are generally clearly defined. In some jurisdictions, the relationship between the actuary and the external auditor is set out in law, regulations or professional guidance. While external auditors and actuaries may be subject to different legal frameworks, their work is closely linked.[20]

Qualifications of the external auditor

174. External auditors need specialised knowledge to review and validate insurers' liabilities and risks. Membership in a professional association, adherence to audit standards, quality control and oversight in the public interest help to ensure the quality of external auditors. Effective oversight of auditors by the audit committee can also help to ensure quality.

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[20] For more detail, refer to the IAIS *Issues Paper on the relationship between the actuary and the external auditor in the preparation and audit of financial reports*, [which is being developed by the Accounting Subcommittee of the IAIS.]

175. Some jurisdictions require insurers to disclose that their external auditors have knowledge and experience commensurate with the nature, scale and complexity of the insurers' business.

Independence of the external auditor

176. An external auditor provides a check on management and to a certain extent also a check on the board. He or she acts independently and does not allow his or her professional judgements to be influenced by management or the board, or by the fact that the auditor may also be providing non-audit services to the insurer (see below).

177. As confirmed by the survey, the independence of the auditor may be promoted by a number of measures, including:

- requirements for conditions for auditor independence and public oversight
- appointment of the auditor by shareholders
- board or audit committee reviews of the independence of the auditor
- audit firm and audit team rotation
- auditor membership in a professional association possessing rules, oversight, and educational qualifications
- requirements for insurers to inform supervisors of the resignation, revocation, or non-renewal of the external auditor.

Conflicts of Interest

178. Some jurisdictions prohibit or limit the provision by the external auditor, or a related party to the external auditor, of non-audit work for an insurer they audit. In most jurisdictions auditors are subject to professional and/or public oversight that includes guidelines or rules to address conflicts of interest.

179. Some jurisdictions require auditor rotation. This may involve limiting the number of years an audit firm or a partner of an audit firm can continuously serve as the external auditor for an insurer. In some jurisdictions, an ex-employee of an insurer is prohibited from auditing the insurer for a certain period of time. Additionally some jurisdictions prohibit the practice of a senior level auditor accepting employment from a former client without a ''cooling off'' period'

Appointment of external auditors

180. Typically the external auditor is appointed by the board or the owners (shareholders or, in the case of mutuals, member-policyholders). In some jurisdictions the appointment of external auditor requires approval from supervisors. Other jurisdictions require that an insurer discloses its policy on external auditor appointment.

Reporting to the audit committee

181. The external auditors are ultimately accountable to the shareholders (or, in the case of mutuals, member-policyholders) or the board, although they usually report to the audit committee.

182. The board or the audit committee also reviews the terms of the external auditor's appointment, their effectiveness, independence and objectivity, any business

relationship between the insurer and the external auditor, taking into account the amount of non-audit services, provided such services are permitted. In some jurisdictions each provision of a non-audit service by the external auditor requires board or audit committee approval. This is to ensure that the nature and extent of such services do not prejudice the external auditors' objectivity and that they can be considered independent.

183. In many jurisdictions external auditors have the right to and regularly meet with the audit committee alone to provide their assessment of management.

Performance measurement, appraisal and dismissal

184. In many jurisdictions performance evaluation of external auditors is undertaken by the board or its audit committee. Some jurisdictions require dismissal of external auditors to be publicly disclosed or reported to the supervisors. Some supervisors have the power to direct the insurer to remove an unsatisfactory appointee from the position.

Disclosure and transparency

185. Public disclosure to the market contributes to good corporate governance in many ways. It allows for comparison on governance practices, helping to identify those insurers using best practices and those lagging behind. It also helps in general with accountability. Companies that do not disclose the same quantity and quality of information as their competitors can be identified. Disclosed information that shows underperformance, potential mismanagement or other shortcomings can be used to hold boards and senior management accountable for their decisions and the insurer's performance. Transparency, in other words, enhances the accountability of insurers to their stakeholders.

186. High standards of transparency and disclosure can have a positive impact on how an insurer manages itself. Disclosure may help the public to understand an insurer's activities, strategies and policies and performance in the areas disclosed and enable them to ask questions where needed. It promotes an understanding of the insurer's relationship with the community or communities where it operates. Disclosure and transparency, as well as proper governance and internal controls, can also contribute to proper corporate conduct and deter fraud and corruption, allowing insurers to compete on the basis of their products offered and to differentiate themselves from insurers who do not practice good governance.

187. Transparency is a prerequisite for effective market discipline. Market discipline, however, requires that market participants have information that enables them to assess an insurer's activities, performance and risks. Thus the information disclosed needs to be timely, reliable, relevant and sufficient, whilst considering the propriety nature of certain information.

188. Many elements of transparency are covered in other documents published by the IAIS[21]. This paper only deals with the following issues from a governance perspective:

- disclosure strategies and policies
- disclosures on governance
- items to disclose
- communication channels
- assurance.

[21] See also *the Standard on disclosures concerning technical performance and risks for non-life insurers and reinsurers*, the *Standard on disclosures concerning investment risks and performance of insurers and reinsurers* and the *Standard on Disclosures concerning technical risks and performance for life insurers,* and Annex 2.It is interesting to note that according to a survey conducted by the IAIS (*Survey on implementation of IAIS Disclosure Standards*, Report on responses, December 2008) the majority of jurisdictions responding to this survey do not fully meet the IAIS disclosure requirements.

Disclosure strategies and policies

189. Most insurers disclose information on their financial position and the risks they are subject to. To ensure that they are disclosing all required information as well as any other information that can benefit their stakeholders, many insurers are reviewing their disclosure strategies and developing disclosure policies on:

- what information to disclose
- how to disclose this information
- the frequency of disclosure and the updating of disclosed information
- the governance process for disclosure, including means to ensure quality and adequacy.

190. Some insurers form a disclosure committee at the board level. Typically this committee is charged with overseeing the insurer’s financial and non-financial disclosure strategy, policy and procedures. It helps ensure compliance with agreed standards and timely collection and publication of information. Where there is no disclosure committee, some boards delegate oversight responsibility for disclosure to the audit committee. Some insurers create a disclosure committee at management level.

Disclosures on governance

191. Increasingly, jurisdictions are setting specific requirements for disclosures on corporate governance, such as:

- information on:
  - governance policy and structures, in particular the division of authority between shareholders (or, in the case of mutuals, member-policyholders), board members and management
  - members of the board and senior management and other key managers
  - composition of the board, including committees
- information on how specific tasks are carried out or how functions are organised, such as:
  - risk management, including:
    - whether a risk committee exists and, if so, its responsibilities
    - whether a separate risk management or chief risk officer exists
    - types of risk reporting to the board and by whom
  - the existence of an internal control framework
- disclosure of the mandates of the board and its committees
- discussion of remuneration policies and practices, in some cases including details on compensation paid to board members and senior management

192. Other items that insurers typically disclose include:

- overall strategies and policies
- ownership structure, including major share ownership and voting rights

- the financial and operating results
- material issues affecting employees and other stakeholders
- intra-group transactions and transactions with parties where board members have an interest
- foreseeable risk factors
- audit fees.

193. The survey results indicate that supervisors are generally satisfied with disclosures. However, specific compliance issues were identified by some jurisdictions, including a reluctance of insurers controlled by dominant shareholders to comply fully with disclosure rules, insufficient disclosures on ownership structures, inadequate transparency on remuneration policies and the level of disclosure on adherence to industry guidelines.

194. The recent financial crisis has led to additional or more detailed information being disclosed, such as information on:

- risk management and compliance practices, including in respect of the existence of a code of conduct or ethics
- accounting (valuation) policies
- relationship with the stakeholders
- risk positions
- write-offs.

Disclosure communication channels

195. Channels used for disclosure purposes include:

- annual reports (as shown by the survey, the most common disclosure channel)
- interim financial reports
- the insurer's external website
- the annual general meeting of shareholders (or of member-policyholders or their representatives in the case of mutuals and cooperatives) or special meetings thereof
- specific periodic reports such as environmental reports or corporate social responsibility (CSR) reports
- specific reports such as prospectuses for public offers and/or listings, merger and takeover documentation
- ad hoc statements.

196. Different jurisdictions have different requirements on what communication channels to use and the timing of disclosures. Most jurisdictions make a distinction between listed insurers that have to comply with more detailed requirements and non-listed insurers that in many instances are only required to publish annual reports. However, in a number of jurisdictions there is a trend towards harmonising disclosure requirements of listed and non-listed insurers. Many insurers voluntarily exceed legal

disclosure requirements and follow best practices on disclosure relevant to the general public and to stakeholders.

Disclosure attestation and assurance

197. In some instances the external auditor, actuary or other independent third-party (such as an investment bank providing an opinion on valuation) may be asked to provide an opinion on the information disclosed. At a minimum this applies to the annual financial statements but it can also apply to other financial and non-financial reports (see the chapters on the actuary and external auditor above).

Relationship with stakeholders

Stakeholders

198. A stakeholder is any person, group or organisation that has a direct or indirect stake in an insurer because it can affect or be affected by the insurer's actions, objectives and policies.

199. Key stakeholders in an insurer include owners (shareholders and, in the case of mutuals, member-policyholders and possible mutual shareholders), employees, policyholders and supervisors. Other stakeholders may include creditors, service providers, unions, rating agencies, equity analysts and the community in which the insurer operates. Thus, insurers need to understand the different interests and “success criteria” of the different stakeholders and reflect these interests in their strategies and policies.

200. Generally stakeholders have a strong interest in the governance practices of insurers because they affect:

- its profitability and thus its capacity to provide a return on capital to shareholders, meet policyholder obligations, provide quality services, hire employees, expand its operations domestically and internationally and contribute to economic and social activity more broadly
- its safety and soundness, and thus its ability to meet its obligations as they come due. Promoting the safety and soundness of insurers also promotes trust and confidence in the financial system more generally
- relationships with policyholders and other stakeholders with a claim on an insurer, and thus the degree to which the interests of these stakeholders are protected. For instance, effective and efficient systems for claims management at an insurer result in fair and efficient processes for the treatment of insurance claims.

201. When confronted with stakeholder conflict, the board plays an important role and in some cases must balance conflicting objectives. The board needs to be guided by clear and understandable principles that are based on sound reasoning and take account of both current and prospective policyholders.

Policyholders

202. In many jurisdictions policyholders are regarded by supervisors as the most important stakeholders. As shown by the survey, both supervisors and insurers attach great importance to policyholder interests and rights in insurer governance structures. Achieving a balance between board members’ duty to shareholders and obligations to policyholders is a key board responsibility.

203. Some jurisdictions specifically require the board to give due regard to policyholders, (in the case of mutuals, member-policyholders) and other creditors. Where this is not the case, it falls to supervisors to ensure (possibly through guidelines) that the interests of policyholders are considered in board and management decision-making. Supervisors play an important role in evaluating insurers’ treatment of policyholders and other stakeholders.

204. In practice, there may be a number of instances where policyholders have a say in corporate decision-making or are effectively given consideration in the governance of an insurer. For example in:

- portfolio transfers
- distribution of surplus funds
- application of regulatory and supervisory principles focused on the consumer, such as “treating customers fairly”, which may lead to certain obligations in sales, marketing, claims management and, ultimately, governance practices and management decision-making. Where such principles are in place, compliance efforts are needed to ensure that the insurer’s practices are consistent with the principles.

205. As the business of many life insurers has grown to include unit-linked investment products, specific governance measures may be established to protect policyholders. For instance, the insurer may develop investment policies for their unit-linked funds, develop policies on product and pricing disclosures to policyholders, and develop a conflicts-of-interest policy. Some jurisdictions do not have special governance rules for unit-linked products, while others pay attention to investment arrangements and policies, provide guidance on unit pricing and, in some cases, are involved in product approval.

Participating policyholders

206. Some insurance contracts (typically life insurance contracts) give policyholders a right to participate in any profits or surplus generated by the insurance policy. Premiums paid under these so-called “participating policies” are paid into the general fund of the insurer or into a special fund (or into special “par” accounts) for participating policyholders and are invested by the insurer. These policies often offer a minimum guaranteed return and may generate excess returns, allowing the insurer to distribute surplus funds to policyholders over the life of the contract or at the end of the contract in addition to the payment of any insured benefit. In the case of stock company insurers, a portion of this surplus may be distributed to shareholders as a reward for risks incurred by the insurer in offering participating policies and any related guarantees. In some jurisdictions, participating policies may also provide policyholders with rights to participate in the annual meeting of the insurer and elect directors to the board.

207. Distributions to participating policyholders may take the form of cash, additions to the level of insurance cover or additions to surrender values. These distributions are called a bonus, dividend, allocation, distribution, etc. Distributions made over the course of the contract typically serve to “smooth” the returns earned on the insurance contract. Distributions are reviewed and approved by the board, and aim to be consistent with the insurer’s solvency position as well as comply with regulatory requirements.

208. A number of governance related issues arise in relation to participating policies, namely:

- *Allocation of surplus between participating policyholders and shareholders*: In the case of stock company insurers, participating policies create a distinct policyholder constituency that has expectations regarding the allocation of any surplus. However, the allocation of any surplus is typically discretionary; the amount of the surplus to be distributed and its timing, and its allocation between participating policyholders and shareholders is generally a decision made by the board on the advice of senior management. This may lead to a conflict between shareholders and participating policyholders. To address this issue, there are, in many jurisdictions, legal requirements on how to distribute the surplus (eg, principle of equity, principle of policyholders' reasonable expectations). Control functions of an insurer can also play a role in ensuring that this issue is addressed in accordance with law or, where the law does not specify this, in an equitable manner. The potential conflict does not arise in mutual insurers where shareholders and policyholders are the members and thus at the same time the owners of the insurer. That said, in mutual insurers, as well as in stock company insurers, there may be questions regarding the appropriate surplus allocation among participating policyholders due to the possibly different types of participating policies and different generations of policies.

- *Transparency and disclosure*: The relatively discretionary nature of the decision regarding the allocation of the surplus, and the complexity of participating policies, may call for a level of transparency regarding the surplus allocation decision. A clear, understandable and transparent process and set of principles for the surplus allocation decision may help to guide policyholder and shareholder expectations, address potential conflicts of interest on the part of those making the allocation decision, and ensure that participating policyholders are treated fairly. To this end, the board of a stock company insurer may establish and publish a formal dividend or bonus policy. The process and principles guiding surplus allocation decisions may be made available to current and prospective participating policyholders and would normally be reviewed and discussed as part of any corporate governance report.

- *Actuarial valuation and advice*: An actuary generally plays an important role in the decision regarding the allocation of the surplus and may be called upon to approve or propose a fair and equitable distribution of the surplus. In most cases, the board has ultimate responsibility for the decision on the surplus. The actuary providing this advice to the board is independent and thus free of any conflicts of interest that may prejudice his or her advice.

- *Role and duties of the board*: In addition to the responsibilities noted above and whether due to principles of law or regulation (eg, treating customers fairly), the board may need to:

    - give due regard to the interests of participating policyholders in its decision-making. For example, where participating policies represent a large share of a stock company insurer's business, the board may establish a special committee to address issues relating to participating policies, possibly involving the actuary

    - directly or through its investment committee, review and monitor investments relating to participating policy business. Again this may also involve the actuary

    - instruct senior management to establish appropriate procedures and controls for the management of participating policy business, which they will subsequently approve and review regularly

- *Voting and attendance at shareholder meetings*: For participating policies with voting rights, governance arrangements ensure appropriate policies for policyholder voting and representation (in the case of stock company insurers) in shareholder meetings. In many jurisdictions the legislative framework for insurers provides a legal basis for these governance policies and procedures.

Tailored disclosure for stakeholders

209. In addition to the types of disclosures discussed in the previous chapter, insurers consider additional disclosures relevant to particular stakeholders. For example, given the importance of policyholders as well as the reliance of a typical policyholder on the insurer's expertise (eg, in financial planning), the insurer makes a particular effort to provide the policyholder with information that is relevant and appropriate to his or her needs and to do it in a way that is understandable to the policyholder.

210. External stakeholders like equity analysts rely on an insurer's public disclosures for information. They rely on the insurer's corporate governance structures and procedures and on the integrity and competence of board members and management, to ensure that at a minimum:

- financial statements accurately and fairly represent the financial condition of the insurer
- the insurer is running its business soundly and will be viable over the long term.

Redress

211. As recommended in the *OECD Guidelines*, policyholders should have access to redress mechanisms, such as being able to register complaints with (and have them considered by) the supervisor or a court. Alternative redress channels, such as internal dispute procedures and independent arbitrators or ombudsmen, can also be helpful. In this context, insurers can establish policies and procedures, including the creation of a unit, to deal with customer complaints and resolve disputes. Insurers may be required to report on the number and nature of complaints to supervisors, which may assist in the identification of governance or market conduct issues. The identification and analysis of policyholder complaints may lead insurers to improve business practices.

212. While alternative redress mechanisms such as arbitration can improve the efficiency with which claims are resolved, many jurisdictions have sought to ensure that access to alternatives does not diminish policyholder access to more conventional dispute resolution processes (eg, supervisor or court systems) that often provide greater rights and protection.

213. Policyholders need to be well informed of, and educated about, insurance products and complaint-handling procedures.

Corporate social responsibility

Definition, interpretation and issues

214. Many jurisdictions and insurers are of the view that insurers have certain responsibilities to society. This general principle is referred to as "corporate social responsibility" (CSR). In some jurisdictions CSR is also known as "corporate citizenship". The survey results confirmed CSR as an issue that has captured the attention of insurers. Specific definitions and applications of this principle have been subject to debate, especially across jurisdictions. There is no one generally accepted definition of the concept. One generally accepted European Union definition of CSR is a 'concept

whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.' For the purposes of this paper, CSR is meant to refer to all approaches including social, philanthropic, community, environmental aspects of strategies, activities and values.

215. The kinds of CSR policies implemented will be influenced by cultural or geographic practices. For example what is prevalent in Northern Europe or North America may not be so in Asia or Africa. Also, in the current economic crisis, broader financial concerns limit the ability of certain stakeholder to influence CSR policy.

216. Issues important to an insurer's approach to CSR include:

- how to ensure that the CSR objectives do not inadvertently conflict with the goals of charitable and other non-governmental organisations
- ensuring organisational understanding and support for the CSR strategy and that the strategy addresses meaningful social and environmental issues
- developing a coherent CSR policy reflecting the insurer's choices
- considering the CSR policy, for example, focusing exclusively on a particular issue, such as microinsurance or microfinance or the support of education, or working with charitable and other non-governmental organisations to achieve certain CSR goals
- determining the CSR disclosures to be made.

Interaction with the supervisor

217. Corporate governance is critical in shaping the direction of a financial institution. Accordingly, the role and attitude of supervisors to governance is critical. Effective corporate governance can assist the supervisor, making it possible for the supervisor to have greater confidence in the work and judgement of an insurer's board, senior management and control functions. While boards have the legal responsibility for the governance and management of an insurer, the role of the supervisor is to review governance practices and ensure that governance responsibilities are being met.

218. In assessing the governance of insurers, the role of supervisors includes:

- determining whether the insurer has adopted and effectively implemented sound corporate governance policies and practices
- assessing the fitness and propriety of board members
- evaluating the effectiveness of boards (eg, reading minutes of boards and committees, asking challenging questions, establishing supervisory expectations)
- on a regular basis, assessing the quality of insurers' internal reporting, risk management, audit and control functions
- evaluating the effects of the insurer's group structure
- assessing the adequacy of governance processes in the area of crisis management and business continuity
- bringing to the board's and senior management's attention problems that they detect through their supervisory activities, while taking care to ensure that the board does not rely on the supervisory authority to assess its corporate governance.

219. Supervisors need to specifically assess the functioning of the board as a whole. This goes beyond assessing the fitness and propriety of an individual member and includes assessing the overall functioning of the group and the group dynamics.

220. Supervisors need to have staff of sufficient quantity, quality and seniority to monitor and assess insurer's performance in the area of corporate governance.

221. Supervisors that establish and enforce effective governance requirements will be able to devote more resources to policyholder protection. The essential role of insurance supervisors is to protect policyholder interests by carefully scrutinising highly technical insurer solvency and risk management practices.

Annex 1 - Definitions of key terms[22]

These terms do not in all cases correspond to the terms used in this paper. The IAIS Governance and Compliance Subcommittee will revisit these definitions in the IAIS Glossary and propose amendments.

Actuary: an actuary is a professional trained in evaluating the financial implications of contingency events. Actuaries require an understanding of the stochastic nature of insurance and other financial services, the risks inherent in assets and the use of statistical models. In the context of insurance, these skills are, for example, often used in establishing premiums, technical provisions and capital levels. [Source: IAIS *Guidance paper on the use of actuaries as part of a supervisory model*, October 2003]

Asset-liability management: the practice of managing a business so that decisions and actions taken with respect to assets and liabilities are coordinated. ALM can be defined as the ongoing process of formulating, implementing, monitoring and revising strategies related to assets and liabilities to achieve an organisation's financial objectives, given the organisation's risk tolerances and other constraints. ALM is relevant to, and critical for, the sound management of the finances of any organisation that invests to meet its future cash flow needs and capital requirements. [Source: Society of Actuaries, Specialty Guide on ALM, 2003, cited in IAIS Standard on asset-liability management, October 2006 and IAIS Issues paper on asset-liability management, October 2006]

Auditor's report: written information provided by the auditor on his examination of the company's annual accounts. [Source: IAIS Guidance paper on the use of actuaries as part of a supervisory model, October 2003]

Board of directors (or management board in a two-tier board system of corporate governance): persons elected by the shareholders of an insurer, or policyholders in the case of a mutual, to manage and set policies. The board is responsible to shareholders or policyholders, appoints the officers of the insurer and sets key policy. [Other related definitions: Management board, Supervisory board, Two-tier board system of corporate governance, unitary board system of corporate governance]. [Source: IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Enterprise Risk Management (ERM): some insurers use ERM as part of their strategic decision-making framework to exploit opportunities to create value and optimise their risk/reward profile. ERM considers all sources of risk to an insurer. ALM is a vital

22 From *IAIS Glossary of terms*, www.iaisweb.org . The Governance and Compliance Subcommittee will propose amendments to some of the terms.

element within an ERM framework. [Source: IAIS Standard on asset-liability management, October 2006]

Fitness and propriety (fit and proper): necessary qualities that must be exhibited by a person performing the duties and carrying out the responsibilities of his or her position with an insurer. Depending on his or her position or legal form these qualities could relate to a proper degree of integrity in attitude, personal behaviour and business conduct, soundness of judgement, degree of knowledge, experience and professional qualifications and financial soundness. [Source: IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Insurance supervisor (supervisory authority): refers, as appropriate, to either the insurance and reinsurance regulator or the insurance and reinsurance supervisor in a jurisdiction. [Source: IAIS Insurance Core Principles, July 2000]

Internal controls: the means by which compliance with the insurer's risk management policies is maintained. Regular reporting, including the use of measurements and metrics required to be within limits specified by the risk management policies, may be used to verify compliance. [Source: IAIS Guidance paper on investment risk management, October 2004]

Investment management: the activity of making and controlling investment decisions [Related definitions: Investment policy, Investment risks, Investment risk management, Investment risk management framework, Investment risk management function, Investment risk management policy, Investments risk exposures, Investments risk limits] [Source: IAIS Guidance paper on investment risk management, October 2004]

Investment policy: the insurer's policy with respect to the overall characteristics for an investment portfolio or for the investments of the insurer as a whole. A statement of a portfolio's investment policy will normally include the objectives of the portfolio, its risk tolerance, constraints to be obeyed in the management of the portfolio, such as minimum liquidity requirements, and a list of eligible assets or asset classes in which the portfolio may be invested, along with a target asset mix and limits on how much the portfolio may diverge from the target. [Source: IAIS Guidance paper on investment risk management, October 2004]

Investment risk management: the process an insurer uses to identify investment risk exposures, and to monitor, measure, report, and mitigate this risk. [Source: IAIS Guidance paper on investment risk management, October 2004]

Investment risk management function: the committees, departments, or persons charged with the responsibility to ensure that the insurer complies with its investment risk management policy and the activities that they carry out, including the oversight of timely corrective action when investment policy constraints are breached and other mitigating action. [Source: IAIS Guidance paper on investment risk management, October 2004]

Investment strategy: the overall direction by the insurer's investment management governing the insurer's investment policy and investment risk management policy. [Source: IAIS Guidance paper on investment risk management, October 2004]

Investments risk limits: the maximum amount of risk exposure that an insurer is prepared to accept. Limits are normally included in the insurer's risk management policy, and monitoring of compliance with these limits is part of the risk management function. [Source: IAIS Guidance paper on investment risk management, October 2004]

Key functionary (ies): individuals defined by legislation, such as board members, directors and senior management of an insurer, who must meet fit and proper requirements. The key functionaries identified may differ depending on the legal form and governance structure of the insurer. [Sources: IAIS Insurance Core Principles, October 2003; IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Management board: the board of directors in a two-tier board system of corporate governance [Other related definitions: Board of directors, Supervisory board, Supervisory body, Two-tier board system of corporate governance, Unitary board system of corporate governance]. [Source: IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Risk management: Risk management is the process whereby the insurer's management takes action to assess and control the impact of past and potential future events that could be detrimental to the insurer. These events can impact both the asset and liability sides of the insurer's balance sheet, and the insurer's cash flow. [Source: IAIS Guidance Paper on Investment Risk Management, October 2004]

Supervisory board: in a two-tier board system of corporate governance, the body whose function is to supervise, on behalf of the shareholders, or policyholders in the case of a mutual, the activities of the management board. [Related definitions: Board of directors, Management board, Two-tier board system of corporate governance, Unitary board system of corporate governance]. [Source: IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Supervisory body: body responsible for supervision of the management of an insurer or intermediary. [Related definitions: Supervisor, Supervisory authority] [Source: IAIS Guidance paper on combating the misuse of insurers for illicit purposes, October 2005]

Two-tier board system of corporate governance: when the corporate governance of an insurer is divided into two boards and executed separately; where a supervisory board supervises a management board. This system exists in jurisdictions in which, for reasons of conflict of interest, a member of the management board (business operational function) cannot be a member of the supervisory board (monitoring function) of the same legal entity at the same time. [Other related definitions: Board of directors, Management board, Supervisory board, Supervisory body, Unitary board system of corporate governance] [Source: IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Unitary board system of corporate governance: when there is only one high level of corporate governance, being the board of directors with all corporate powers, as opposed to a two-tier board system where a supervisory board supervises a management board. [Related definitions: Board of directors, Management board, Supervisory board, Supervisory body, Two-tier board system of corporate governance]. [Source: IAIS Standard on fit and proper requirements and assessment for insurers, October 2005]

Whistleblowing: the exposure and reporting of fraud by a member of the public or within an insurer by a director of the board, a manager or a member of staff. [Source: IAIS Guidance paper on preventing, detecting and remedying fraud in insurance, October 2006]

Annex 2 – Other IAIS governance related work

As discussed in paragraph 2 of this issues paper, some topics covered in the paper are also dealt with in other IAIS and OECD papers. The issues paper is distinct in having an insurer corporate governance focus and discusses a variety of topics from this perspective. Throughout the paper relevant topics are addressed in a manner which is consistent with existing IAIS and OECD work.

This annex provides more detail on the most relevant of these IAIS papers[23].

- IAIS *Standard on enterprise risk management for capital adequacy and solvency purposes* (October 2008) and *Guidance paper on enterprise risk management for capital adequacy and solvency purposes* (October 2008) which requires that as part of its overall governance structure, an insurer should establish, and operate within, a sound Enterprise Risk Management (ERM) framework which is appropriate to the nature, scale and complexity of its business and risks. Further, the ERM framework should be integrated with the insurer's business operations and culture, and address all reasonably foreseeable and relevant material risks faced by the insurer in accordance with a properly constructed risk management policy. The establishment and operation of the ERM framework should be led and overseen by the insurer's board and senior management. The ERM Standard also addresses other related governance topics such as risk identification and measurement, the requirement for a risk management policy and risk tolerance statement and the need for risk responsiveness and a feedback loop. The Standard also requires that an insurer should regularly perform its own risk and solvency assessment (ORSA) to provide the board and senior management with an assessment of the adequacy of its risk management and current, and likely future, solvency position. The Standard also outlines the role of supervision in risk management.
- IAIS *Standard on the use of Internal Models for regulatory capital purposes* (October 2008) and IAIS *Guidance paper on the use of Internal Models for regulatory capital purposes* (October 2008) which contain broad governance requirements for insurers, focusing on general provisions on the use of an internal model to determine regulatory capital requirements and initial validation and supervisory approval, with particular regard focusing on a statistical quality test, calibration test, use test and governance and documentation. The Standard requires that the insurer's board and senior management should have overall control of and responsibility for the construction and use of the internal model for risk management purposes, and ensure there is sufficient understanding of the model's construction at appropriate levels within the insurer's organisational structure. In particular, the board and senior management should understand the consequences of the internal model's outputs and limitations for risk and capital management decisions. The Standard also requires ongoing validation and supervisory approval and supervisory reporting and public disclosure.

[23] Please note that this is not an exhaustive list of relevant documents, see also footnote 1.

- IAIS *Guidance paper on Stress testing by Insurers* (October 2003) which outlines that prudent, well-managed insurers would undertake stress testing as a matter of good corporate governance, which should result in better internal controls, governance and risk management. The paper outlines that to be truly effective, stress tests should be considered as a fundamental element in an insurer's overall risk management framework and that stress testing should contribute to the understanding that the board and management has of the risks facing the insurer. The paper also outlines that the board and management must understand the assumptions underlying the stress testing, as well as the result, and that stress tests can help an insurer to develop and assess alternative strategies for mitigating risks. As such, stress tests are viewed as a necessary tool for insurance management and are a fundamental element of an insurer's overall risk management framework and capital adequacy determination.

- IAIS *Standard on the structure of regulatory capital requirements* (October 2008) and IAIS *Guidance paper on the structure of regulatory requirements* (October 2008) which recognises that insurer solvency takes a central position in risk management by insurers and in insurance supervision. The Standard and Guidance paper addresses the structure of regulatory capital requirements in a supervisory regime for solvency assessment.

- IAIS *Standard on Asset-Liability Management* (October 2006) which focuses on many governance requirements and issues such as the purpose and framework for ALM, risks covered by ALM and the relatedness to an insurer's risk tolerance and related ALM policies. The Standard requires that the board of directors should approve the insurer's strategic ALM policy, taking account of asset-liability relationships, the insurer's overall risk tolerance, risk and return requirements, solvency position and liquidity requirements and that senior management are responsible for implementing the ALM policy. The Standard also focuses upon the inter-relationship of insurer functions and on controls and reporting, in particular, it requires that the insurer should develop and implement controls and reporting procedures for its ALM policies that are appropriate for its business and the risks to which it is exposed and that these should be monitored closely and reviewed regularly.

- IAIS *Principles on Group-Wide Supervision* (October 2008). These Principles are designed to establish an internationally acceptable framework that contributes to ensuring appropriate streamlining, consistency, efficiency and effectiveness of supervision on a group-wide basis. The Principles focus, initially, on the aims of group-wide supervision and then on the means to achieve these aims (eg the responsibilities of different supervisors, mechanisms of cooperation and exchange of information). In developing these Principles, regard was given to the work of the Joint Forum and other relevant organisations, with the aim of achieving appropriate consistency.

- IAIS *Supervisory Standard on Fit and Proper Requirements and Assessment for Insurers* (October 2005). This standard extends the scope of the Joint Forum paper Fit and Proper Principles, to single insurance entities and to insurance groups. The objective is to ensure that significant owners and key functionaries do not pose a risk to the interests of present and future policyholders and beneficiaries of these entities.

- IAIS *The Use of Actuaries as Part of a Supervisory Model* (October 2003). This paper considers the use of an actuary as part of an insurance supervisory model. In some jurisdictions where use is made of an actuary in the supervisory model, this use is referred to as an 'appointed actuary' or a 'responsible actuary' system. While this system may have variations, it is essentially based upon the mandated use of an actuary by insurers, with that actuary having specified reporting or certification responsibilities to both the insurer and the supervisor.

- IAIS *Standard on disclosures concerning technical performance and risks for non-life insurers and reinsurers*, IAIS *Standard on disclosures concerning investment risks and performance of insurers and reinsurers* and IAIS *Standard on Disclosures concerning technical risks and performance for life insurers.* These standards set out minimum requirements on insurers and reinsurers to disclose information concerning their technical risks and performance and their investment risk.

Annex 3 – Other OECD governance related work

The Organisation for Economic Co-operation and Development ("OECD") *Principles of Corporate Governance* are internationally recognised standards on corporate governance. The *Principles of Corporate Governance* were adopted in 1999 and have since become an international benchmark for policymakers, investors, corporations and other stakeholders worldwide. The *Principles* cover a number of key areas related to corporate governance: (i) the foundations for an effective corporate governance framework; (ii) the rights of shareholders and key ownership functions; (iii) the equitable treatment of shareholders; (iv) the role of stakeholders; (v) disclosure and transparency; and (vi) the responsibilities of the board. The *Principles* are one of the twelve key international standards for sound financial systems of the Financial Stability Forum. The *Principles* provide the basis for an extensive programme of cooperation between OECD and non-OECD countries and underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes. The *Principles* were revised most recently in 2004 and a Methodology for assessing implementation was issued in 2007. The *Principles* will be reassessed as part of the OECD response to the financial crisis.

In order to capture the specificities of the governance of insurers and private pensions and complement the *Principles*, the OECD Insurance and Private Pensions Committee ("IPPC") and its Working Party on Private Pensions ("WPPP") elaborated more specific corporate governance guidelines for insurers and private pensions. The OECD *Guidelines for Insurers' Governance* and *Guidelines for Pension Fund Governance* were approved by OECD governments in April 2005.

The OECD *Guidelines for Insurers' Governance* provide governments and insurers with a roadmap for promoting corporate governance and thereby better protecting policyholders and shareholders. The *Guidelines* covers matters such as:

- The governance, structure, composition and responsibilities of the board of directors
- The fitness, integrity and accountability of board members
- Internal governance mechanisms, including internal control and reporting systems
- The roles and responsibilities of the appointed actuary and external auditor
- Financial reporting and disclosure to stakeholders
- Redress mechanisms.

As required by the OECD Council, the *Guidelines for Insurers' Governance* are currently under review for possible updating or revision in light of developments since 2005, including the recent financial crisis.

The OECD *Guidelines for Pension Fund Governance* lay down a framework for strengthening pension fund governance in order to better serve the needs of pension fund members and beneficiaries. The *Guidelines* address elements of the governance structure such as the governing body, auditor, actuary, and custodian, as well as governance mechanisms such as internal controls, reporting and disclosure. The *Guidelines* have been reviewed by the WPPP, with revised draft *Guidelines* published for public consultation in mid-2008. The proposed revised *Guidelines* tackle issues such as stakeholder representation in pension fund boards, the requirements of expertise and knowledge of the board and the implementation of risk-based governance structures and mechanisms.