

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

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## Responding to this paper

EIOPA welcomes comments on the Consultation Paper on the Proposal for Guidelines on the System of Governance.

The consultation package includes:

- The Consultation Paper on the System of Governance
- Template for comments

Please send your comments to EIOPA in the provided Template for Comments, by email [CP-13-008@eiopa.europa.eu](mailto:CP-13-008@eiopa.europa.eu), by 19 June 2013.

Contributions not provided in the template for comments, or sent to a different email address, or after the deadline will not be processed.

EIOPA invites comments on any aspect of this paper. Comments are most helpful if they:

- contain a clear rationale; and
- describe any alternatives EIOPA should consider.

### Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise in the respective field in the template for comments. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with EIOPA's rules on public access to documents<sup>1</sup>. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by EIOPA's Board of Appeal and the European Ombudsman.

### Data protection

Information on data protection can be found at [www.eiopa.europa.eu](http://www.eiopa.europa.eu) under the heading 'Legal notice'.

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<sup>1</sup> [https://eiopa.europa.eu/fileadmin/tx\\_dam/files/aboutceiops/Public-Access-\(EIOPA-MB-11-051\).pdf](https://eiopa.europa.eu/fileadmin/tx_dam/files/aboutceiops/Public-Access-(EIOPA-MB-11-051).pdf)  
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## **Consultation Paper Overview & Next Steps**

EIOPA carries out consultations in the case of Guidelines and Recommendations in accordance to Article 16 (2) of the EIOPA Regulation.

This Consultation Paper is being issued as part of the preparation for the implementation of Solvency II by national competent authorities and insurance and reinsurance undertakings and groups.

This Consultation Paper presents the draft Guidelines and a technical annex.

The analysis of the expected impact from the proposed policy is covered under the Annex I (Impact Assessment).

### **Next steps**

EIOPA will consider the feedback received and expects to publish a final report on the consultation subsequently.

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# **1. Guidelines**

## **Introduction**

- 1.1. According to Article 16 of Regulation (EU) 1094/2010 of 24 November 2010 (hereafter, EIOPA Regulation or the Regulation)<sup>2</sup> EIOPA is issuing Guidelines addressed to national competent authorities on how to proceed in the preparatory phase leading up to the applications of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)<sup>3</sup>.
- 1.2. These Guidelines are based on Articles 40 to 49, Article 93, Article 132 and Article 246 of Solvency II.
- 1.3. In the absence of a political agreement on Omnibus II, European national competent authorities may be forced to develop national solutions in order to ensure sound risk sensitive supervision. Instead of reaching consistent and convergent supervision in the EU, different national solutions may emerge to the detriment of a good functioning internal market.
- 1.4. It is of key importance that there will be a consistent and convergent approach with respect to the preparation of Solvency II. These Guidelines should be seen as preparatory work for Solvency II by fostering preparation with respect to key areas of Solvency II in order to ensure proper management of undertakings and to ensure that supervisors have sufficient information at hand. These areas are the system of governance, including risk management system and a forward looking assessment of the undertaking's own risks (based on the Own Risk and Solvency Assessment principles, known as ORSA), pre-application for internal models, and submission of information to national competent authorities.
- 1.5. Early preparation is a key in order to ensure that when Solvency II is fully applicable undertakings and national competent authorities will be well prepared and able to apply the new system. For this, national competent authorities are expected to engage with undertakings in a close dialogue.
- 1.6. As part of the preparation for the implementation of Solvency II, national competent authorities should put in place from 1 January 2014 the Guidelines as set out in this document so that insurance and reinsurance undertakings take the appropriate steps.

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<sup>2</sup> OJ L 331, 15.12.2010, p. 48–83

<sup>3</sup> OJ L 335, 17.12.2009, p.1-155

- 1.7. National competent authorities should send to EIOPA, a progress report on the application of these Guidelines by the end of February following each relevant year, the first being by 28 February 2015 based on the period 1 January 2014 to 31 December 2014.
- 1.8. These Guidelines include Guidelines on the prudent person principle. National competent authorities are expected to ensure that undertakings during the preparatory period already take into account this principle on top of the system of regulatory quantitative limits applicable under the current supervisory regime. In addition national competent authorities are expected to ensure that progress is made by undertakings to make the necessary transition over the duration of the interim period towards having all the requisite governance surrounding investments in place. This does not imply that undertakings' investment portfolios already have to be changed to the extent undertakings would consider necessary when the Solvency II regime is fully applicable.
- 1.9. The Guidelines concerning the actuarial function contain references to capital requirements and technical provisions. These references are to be understood as references to Solvency II requirements. A majority of the tasks of the actuarial function concerns the coordination of Solvency II technical provisions. During the preparatory period these tasks are mainly relevant with regard to the submission of interim information to the supervisory authority. There is no full framework for technical provisions valuation during this period. For the purpose of the preparatory reporting and only for that purpose the framework will be provided later.
- 1.10. National competent authorities are expected to ensure that these Guidelines are applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of the insurance and reinsurance undertaking. The Guidelines already reflect the application of the principles of proportionality by having the principle embedded.
- 1.11. The national competent authorities should apply the Guidelines to both individual undertakings and mutatis mutandis at the level of the group. Additionally, for groups national competent authorities need to apply the group specific Guidelines.
- 1.12. The Guidelines shall apply from 1 of January 2014.

## **Section I: General Provisions for preparatory Guidelines**

### **Guideline 1- General provisions for Guidelines**

- 1.13. National competent authorities should take the appropriate steps in order to put in place from 1 January 2014 the present Guidelines on System of Governance.
- 1.14. National competent authorities should ensure that insurance and reinsurance undertakings and groups take the appropriate steps to:
- a. build an effective system of governance according to the Solvency II Directive which provides for sound and prudent management;
  - b. build an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies; and
  - c. build qualitative information supporting the system of governance that will allow national competent authorities to review and evaluate the quality of the information.

### **Guideline 2 - Progress report to EIOPA**

- 1.15. National competent authorities should send to EIOPA, a progress report on the application of these Guidelines by the end of February following each relevant year, the first being by 28 February 2015 based on the period 1 January 2014 to 31 December 2014.

## **Section II: System of Governance**

### **Chapter I: General governance requirements**

#### **Guideline 3 - The administrative, management or supervisory body (AMSB)**

- 1.16. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the undertaking has appropriate interaction with any committee it establishes as well as with senior management and with other key functions in the undertaking, requesting information from them proactively and challenging that information when necessary.
- 1.17. In accordance with Article 246 of Solvency II, national competent authorities should ensure that at group level, the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements has an appropriate interaction with the administrative, management or supervisory bodies of all entities within the group, requesting information proactively in the matters that may affect the group and challenging the decision making both at group and entity level.

## **Guideline 4 – Organisational and operational structure**

- 1.18. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking has organisational and operational structures aimed at supporting the strategic objectives and operations of the undertaking. Such structures should be able to be adapted to changes in the strategic objectives, operations or in the business environment of the undertaking within an appropriate period of time.
- 1.19. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements at group level assesses how changes to the group's structure impact on the soundness of the undertaking and makes the necessary adjustments in a timely manner.
- 1.20. In accordance with Article 246 of Solvency II, national competent authorities should ensure that, in order to take appropriate measures, the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements at group level knows the corporate organisation of the group, the purpose of its different entities and the links and relationships between them as well as keep itself informed about the risks arising from the group's structure.

## **Guideline 5 - Key functions**

- 1.21. In accordance with Articles 44, 46, 47 and 48 of Solvency II, national competent authorities should ensure that the undertaking appropriately implements the following key functions: risk management function, compliance function, internal audit function and actuarial function.
- 1.22. In accordance with Articles 44, 46, 47 and 48 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level appropriately implements the following key functions: risk management function, compliance function, internal audit function and actuarial function at the level of the group.

## **Guideline 6 – Decision-making**

- 1.23. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking ensures that at least two persons effectively run the undertaking. That implies that any significant decision of the undertaking involves at least two persons who effectively run the undertaking before the decision is being implemented.

## **Guideline 7 - Documentation of decisions taken at the level of the AMSB**



- 1.24. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking appropriately documents the decisions taken at the level of the administrative, management or supervisory body of the undertaking and how information from the risk management system has been taken into account.

### **Guideline 8 - Internal review of the system of governance**

- 1.25. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the undertaking determines the scope and frequency of the internal reviews of the system of governance, taking into account the nature, scale and complexity of the business both at individual and at group level, as well as the structure of the group.
- 1.26. In accordance with Article 41 of Solvency II, national competent authorities should ensure that it is up to the undertaking to decide who is to perform the reviews within the undertaking.
- 1.27. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the scope, findings and conclusions of the review are properly documented and reported to the administrative, management or supervisory body of the undertaking. Suitable feedback loops are necessary to ensure follow-up actions are undertaken and recorded.

### **Guideline 9 – Policies**

- 1.28. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking aligns all policies required as part of the system of governance with each other and with its business strategy. The policies should clearly set out at least:
- a) the goals pursued by the policy;
  - b) the tasks to be performed and the person or role responsible for them;
  - c) the processes and reporting procedures to be applied; and
  - d) the obligation of the relevant organisational units to inform the risk management, internal audit and the compliance and actuarial functions of any facts relevant for the performance of their duties.
- 1.29. In accordance with Article 41 of Solvency II, national competent authorities should ensure that in the policies that cover the key functions, the undertaking also addresses the position of these functions within the undertaking, their rights and powers.

## **Guideline 10 - Contingency plans**

- 1.30. In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking identifies risks to be addressed by contingency plans based on the areas where it considers itself to be especially vulnerable and reviews, updates and tests these contingency plans on a regular basis.

## **Chapter II: Fit and Proper**

### **Guideline 11 – Fit requirements**

- 1.31. In accordance with Article 42 of Solvency II, national competent authorities should ensure that persons who effectively run the undertaking or have other key functions, including members of the administrative, supervisory or management body of the undertaking are 'fit' and take account of the respective duties allocated to individual members to ensure appropriate diversity of qualifications, knowledge and relevant experience to ensure that the undertaking is managed and overseen in a professional manner.
- 1.32. In accordance with Article 42 of Solvency II, national competent authorities should ensure that the undertaking ensures that the members of the administrative, management or supervisory body collectively possess at least qualification, experience and knowledge about:
- a) insurance and financial markets;
  - b) business strategy and business model;
  - c) system of governance;
  - d) financial and actuarial analysis; and
  - e) regulatory framework and requirements.

### **Guideline 12 - Proper requirements**

- 1.33. In accordance with Article 42 of Solvency II, national competent authorities should ensure that the undertaking, when assessing whether a person is 'proper', includes an assessment of that person's honesty and financial soundness based on relevant evidence regarding their character, personal behaviour and business conduct including any criminal, financial, supervisory aspects regardless of location. The period of limitation of the committed offence is judged based on national law or practice.

### **Guideline 13 - Fit and proper policies and procedures**

1.34. In accordance with Article 41 and 42 of Solvency II, national competent authorities should ensure that the undertaking has a policy on the fit and proper requirements, which includes at least:

- a) a description of the procedure for assessing the fitness and propriety of the persons who effectively run the undertaking or have other key functions, both when being considered for the specific position and on an on-going basis;
- b) a description of the situations that give rise to a re-assessment of the fit and proper requirements; and
- c) a description of the procedure for assessing the fit and proper requirements of other relevant personnel not subject to the requirements of Article 42 of Solvency II according to internal standards, both when being considered for the specific position and on an on-going basis.

#### **Guideline 14 - Outsourcing of key functions**

1.35. In accordance with Article 42 and 49 of Solvency II, national competent authorities should ensure that the undertaking applies the fit and proper requirements to the persons employed by the service provider or sub service provider to perform an outsourced key function.

1.36. In accordance with Article 42 and 49 of Solvency II, national competent authorities should ensure that the undertaking designates a person within the undertaking with overall responsibility for the outsourced key function who is fit and proper and possesses sufficient knowledge and experience regarding the outsourced key function to be able to challenge the performance and results of the service provider.

### **Chapter III: Risk Management**

#### **Guideline 15 - Role of the administrative, management or supervisory body in the risk management system**

1.37. In accordance with Article 44 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the undertaking is ultimately responsible for ensuring the effectiveness of the risk management system, setting the undertaking's risk appetite and overall risk tolerance limits as well as approving the main risk management strategies and policies.

1.38. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements at group level is

responsible for the effectiveness of the risk management system of the whole group. This risk management system should include at least:

- a) the strategic decisions and policies on risk management at group level;
- b) the definition of group's risk appetite and overall risk tolerance limits; and
- c) the identification, measurement, management and control of risks at group level.

1.39. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level ensures that such strategic decisions and policies are consistent with the group's structure, size and the specificities of the entities in the group and that the specific operations and associated risks of each entity in the group are covered and in addition, it ensures that an integrated, consistent and efficient risk management of the group is put in place.

#### **Guideline 16 - Risk management policy**

1.40. In accordance with Article 44 of Solvency II, national competent authorities should ensure that the undertaking establishes a risk management policy which at least:

- a) defines the risk categories and the methods to measure the risks;
- b) outlines how the undertaking manages each relevant category and area of risks;
- c) describes the connection with the overall solvency needs assessment as identified in the forward looking assessment of the undertaking's own risks (based on the ORSA principles), the regulatory capital requirements and the undertaking's risk tolerance limits;
- d) specifies risk tolerance limits within all relevant risk categories in line with the undertaking's overall risk appetite; and
- e) sets out the frequency and content of regular stress tests, and describe the situations that would warrant special stress tests.

#### **Guideline 17 - Risk management function: general tasks**

1.41. In accordance with Article 44 of Solvency II, national competent authorities should ensure that the undertaking requires the risk management function to report to the administrative, management or supervisory body on risks that have been identified as potentially material. The risk management function should also report on other specific areas of risks both on its own initiative and following

requests from the administrative, management or supervisory body.

- 1.42. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level ensures that the risk policy is implemented consistently across the group.

### **Guideline 18 - Underwriting and reserving risk**

- 1.43. In accordance with Article 44 of Solvency II, national competent authorities should ensure that in its risk management policy, the undertaking covers at least the following with regard to underwriting and reserving risk:

- a) the types and characteristics of the insurance business, for example, the type of insurance risk the undertaking is willing to accept;
- b) how the adequacy of premium income to cover expected claims and expenses is to be ensured;
- c) the identification of the risks arising from the undertaking's insurance obligations, including embedded options and guaranteed surrender values in its products;
- d) how, in the design of a new insurance product and the premium calculation, the undertaking takes account of the constraints related to investments; and
- e) how, in the design of a new insurance product and the premium calculation, the undertaking takes account of reinsurance or other risk mitigation techniques.

### **Guideline 19 – Operational risk**

- 1.44. In accordance with Article 44 of Solvency II, national competent authorities should ensure that in the risk management policy, the undertaking covers at least the following with regard to operational risk:

- a) identification of the operational risks it is or might be exposed to and the way to mitigate them;
- b) activities and internal processes in place in the undertaking, including the IT system supporting them; and
- c) risk tolerance limits with respect to the undertaking's key operational risk areas.

- 1.45. In accordance with Article 44 of Solvency II, national competent authorities should ensure that the undertaking has processes to identify, analyse and report on operational risk events. For this purpose, it should set up a system for collecting and monitoring operational risk events.

1.46. In accordance with Article 44 of Solvency II, national competent authorities should ensure that for the purposes of operational risk management, the undertaking develops and analyses an appropriate set of operational risk stress scenarios based on at least the following approaches:

- a) the failure of a key process, personnel or system; and
- b) the occurrence of external events.

#### **Guideline 20 – Control and documentation of risk-mitigation**

1.47. In accordance with Article 44 of Solvency II, national competent authorities should ensure that for the purposes of proper use of reinsurance and other risk mitigation techniques the undertaking analyses, assesses and documents the effectiveness of all risk mitigation techniques employed.

#### **Guideline 21 - Reinsurance and other risk-mitigation techniques – risk management policy**

1.48. In accordance with Article 44 of Solvency II, national competent authorities should ensure that in the risk management policy the undertaking covers at least the following with regard to reinsurance and other risk mitigation techniques:

- a) identification of the level of risk transfer appropriate to the undertaking's defined risk limits and which kind of reinsurance arrangements are most appropriate considering the undertaking's risk profile;
- b) principles for the selection of reinsurance counterparties and procedures for assessing and monitoring the creditworthiness and diversification of reinsurance counterparties;
- c) procedures for assessing the effective risk transfer and consideration of basis risk;
- d) liquidity management to deal with any timing mismatch between claims' payments and reinsurance recoveries; and
- e) where applicable, procedures for ensuring that unit-linked policyholders continue to receive benefits in line with aims and objectives originally communicated to them.

#### **Guideline 22 - Asset-liability management**

1.49. In accordance with Article 44 of Solvency II, national competent authorities should ensure that in its risk management policy the undertaking covers at

least the following information with regard to asset-liability management:

- a) a description of the procedure for identification and assessment of different natures of mismatches between assets and liabilities, at least with regard to terms and currency;
- b) a description of mitigation techniques to be used and the expected effect of relevant risk-mitigating techniques on asset-liability management;
- c) a description of deliberate mismatches permitted and the content and frequency of stress-tests to be conducted and monitored; and
- d) a description of the underlying methodology and frequency of stress tests and scenario tests to be carried out.

### **Guideline 23 - Investment risk**

1.50. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that in its risk management policy, the undertaking covers at least the following with regard to investments:

- a) the level of security, quality, liquidity, profitability and availability the undertaking is aiming for with regard to the whole portfolio of assets and how it plans to achieve this;
- b) the internal quantitative limits on assets and exposures, including off-balance sheet exposures, that are to be established to help the undertaking achieve its desired level of security, quality, liquidity, profitability and availability for the portfolio;
- c) consideration of the financial market environment;
- d) the conditions under which the undertaking can pledge or lend assets;
- e) the link between market risk and other risks in highly adverse scenarios;
- f) the procedure for appropriately valuing and verifying the investment assets;
- g) the procedures to monitor the performance and review the policy when necessary; and
- h) how the assets are to be selected in the best interest of policyholders and beneficiaries.

### **Guideline 24 - Liquidity risk**

1.51. In accordance with Article 44 of Solvency II, national competent authorities should ensure that in its risk management policy, the undertaking covers at least the following items with regard to liquidity risk:

- a) the procedure for determining the level of mismatch between the cash

inflows and the cash outflows of both assets and liabilities, including expected cash flows of direct insurance and reinsurance such as claims, lapses or surrenders;

- b) consideration of total liquidity needs in the short and medium term including an appropriate liquidity buffer to guard against a liquidity shortfall;
- c) consideration of the level and monitoring of liquid assets, including a quantification of potential costs or financial losses arising from an enforced realisation;
- d) consideration of the identification and cost of alternative financing tools; and
- e) consideration of the effect on the liquidity situation of expected new business.

## **Chapter IV: The “prudent person” principle and the system of governance**

### **Guideline 25 - Investment risk management**

- 1.52. In accordance with Article 132 of Solvency II, national competent authorities should ensure that for the purpose of the investment risk management the undertaking develops its own set of key risk indicators adapted to its risk management policy and business strategy.
- 1.53. In accordance with Article 132 of Solvency II, national competent authorities should ensure that the undertaking does not solely depend on the information provided by financial institutions, asset managers and rating agencies. In making its investment decisions, the undertaking should take into account the risks associated with the investments without relying only on the risk being adequately captured by the capital requirements.

### **Guideline 26 – Assessment of non-routine investment activities**

- 1.54. In accordance with Article 132 of Solvency II, national competent authorities should ensure that before performing any investment or investment activity of a non-routine nature the undertaking carries out an assessment of at least:
- a) its ability to perform and manage the investment or the investment activity;
  - b) the risks specifically related to the investment or the investment activity and the impact of the investment or the investment activity on the undertaking’s risk profile;
  - c) the consistency of the investment or investment activity with the beneficiaries and policyholder’s interest, liability constraints set by the undertaking and efficient portfolio management; and
  - d) the impact of this investment or investment activity on the quality, security,



liquidity, profitability and availability of the whole portfolio.

- 1.55. In accordance with Article 132 of Solvency II, national competent authorities should ensure that where the investment or investment activity entails a significant risk or change in the risk profile, the undertaking's risk management function communicates such a risk or change in the risk profile to the administrative, management or supervisory body of the undertaking.

### **Guideline 27 - Unit-linked and index-linked contracts**

- 1.56. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the investments of unit-linked and index-linked contracts of the undertaking are selected in the best interest of policyholders and beneficiaries taking into account any disclosed policy objectives.
- 1.57. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that, in the case of unit-linked business, the undertaking takes into account and manage the constraints related to unit-linked contracts, in particular liquidity constraints.

### **Guideline 28 - Assets not admitted for trading on a regulated financial market**

- 1.58. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking implements, manages, monitors and controls procedures in relation to investments that are not admitted to trading on a regulated financial market or to complex products, which are difficult to value.
- 1.59. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking treats assets admitted to trading, but not traded or traded on a non-regular basis, similarly to those assets not admitted to trading on a regulated financial market.

### **Guideline 29 - Derivatives**

- 1.60. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking, when it uses derivatives, implements the procedures in line with its risk management policy on investments to monitor the performance of these derivatives.
- 1.61. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking demonstrates how the quality, security, liquidity or profitability of the whole portfolio is improved without significant impairment of any of these features where derivatives are used to facilitate efficient portfolio management.

- 1.62. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking documents the rationale and demonstrates the effective risk transfer obtained by the use of the derivatives where derivatives are used to contribute to a reduction of risks or as a risk mitigation technique.

### **Guideline 30 - Securitised instruments**

- 1.63. In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that, where the undertaking invests in securitised instruments, it ensures that its interests and the interests of the originator concerning the securitised assets are well understood and aligned.

## **Chapter V: Own fund requirements and the system of governance**

### **Guideline 31 – Capital Management Policy**

- 1.64. In accordance with Article 41 and 93 of Solvency II, national competent authorities should ensure that the undertaking should be developing a capital management policy which includes:
- a. a description of the procedure to ensure that own fund items, both at issue and subsequently, meet the requirements of the applicable capital and distribution regime and are classified correctly where the applicable regime requires;
  - b. a description of the procedure to monitor the issuance of own fund items according to the medium term capital management plan;
  - c. a description of the procedure to ensure that the terms and conditions of any own fund item are clear and unambiguous in relation to the criteria of the applicable capital regime; and
  - d. a description of the procedures to
    - i. ensure that any policy or statement in respect of ordinary share dividends is taken into account in consideration of the capital position; and
    - ii. process to be conducted to identify, document and action instances in which distributions on an own funds item are expected to be deferred or cancelled.

### **Guideline 32 – Medium-term Capital Management Plan**

- 1.65. In accordance with Article 41 and 93 of Solvency II, national competent authorities should ensure that the undertaking is developing a medium-term capital management plan which is to be monitored by the administrative, management or supervisory body of the undertaking and which includes at least considerations of:

- a. any planned capital issuance;
  - b. the maturity, incorporating both the contractual maturity and any earlier opportunity to repay or redeem, relating to the undertaking's own fund items;
  - c. how any issuance, redemption or repayment of, or other variation in the valuation of, an own funds item affects the application of any limits in the applicable capital regime; and
  - d. the application of the distributions policy.
- 1.66. In accordance with Article 41 and 93 of Solvency II, national competent authorities should ensure that the undertaking takes into account in the capital management plan the output from the risk management systems and the forward looking assessment of the undertaking's own risks (based on the ORSA principles).

## **Chapter VI: Internal Controls**

### **Guideline 33 – Internal Control environment**

- 1.67. In accordance with Article 46 of Solvency II, national competent authorities should ensure that the undertaking promotes the importance of performing appropriate internal controls by ensuring that all personnel are aware of their role in the internal control system. The control activities should be commensurate to the risks arising from the activities and processes to be controlled.
- 1.68. In accordance to Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level ensures a consistent implementation of the internal control systems across the group.

### **Guideline 34 – Monitoring and reporting**

- 1.69. In accordance with Article 46 of Solvency II, national competent authorities should ensure that the monitoring and reporting mechanisms within the internal control system of the undertaking provide the administrative, management or supervisory body with the relevant information for the decision-making processes.

## **Chapter VII: Internal audit function**

### **Guideline 35 – Independence**

- 1.70. In accordance with Article 47 of Solvency II, national competent authorities should ensure that when performing an audit and when evaluating and reporting the audit results, the internal audit function of the undertaking is not subject to instructions from the administrative, management or supervisory body that can

impair its independence and impartiality.

### **Guideline 36 - Internal audit policy**

1.71. In accordance with Articles 41 and 47 of Solvency II, national competent authorities should ensure that the undertaking has an internal audit policy which covers at least the following areas:

- a. the terms and conditions according to which the internal audit function can be called upon to give its opinion or assistance or to carry out other special tasks;
- b. internal rules setting out the procedures the person responsible for the internal audit function needs to follow before informing the supervisory authority; and
- c. the criteria for the rotation of staff assignments.

1.72. In accordance with Articles 41 and 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level ensures that the audit policy at the level of the group demonstrates that the internal audit function is able to:

- a. coordinate the internal audit activity across the group; and
- b. ensure compliance with the internal audit requirements at the group level.

### **Guideline 37 – Internal audit plan**

1.73. In accordance with Article 47 of Solvency II, national competent authorities should ensure that the internal audit function of the undertaking:

- a. establishes, implements and maintains an audit plan setting out the audit work to be undertaken in the upcoming years, taking into account all activities and the complete system of governance of the undertaking;
- b. takes a risk-based approach in deciding its priorities;
- c. reports the audit plan to the administrative, management or supervisory body;
- d. issues recommendations based on the result of work carried out in accordance with point (a) and submit a written report on its findings and recommendations to the administrative, management or supervisory body on at least an annual basis; and
- e. verifies compliance with the decisions taken by the administrative, management or supervisory body on the basis of those recommendations referred to in point (d).

1.74. In accordance with Article 47 of Solvency II, national competent authorities

should ensure that where necessary, the internal audit function may carry out audits which are not included in the audit plan.

### **Guideline 38 - Internal audit findings and recommendations**

- 1.75. In accordance with Article 47 of Solvency II, national competent authorities should ensure that the recommendations of the internal audit function of the undertaking includes the envisaged period of time to remedy the shortcomings and the persons responsible for doing so.

### **Guideline 39 – Internal audit report for the administrative, management or supervisory body**

- 1.76. In accordance with Article 47 of Solvency II, national competent authorities should ensure that the internal audit function of the undertaking issues at least annually an internal audit report to the administrative, management or supervisory body. This report should include information on the extent to which the internal audit function's objectives, the execution of the audit plan and the follow-up of audit recommendations have been achieved.

## **Chapter VIII: Actuarial Function**

### **Guideline 40 - Tasks of the actuarial function**

- 1.77. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the undertaking takes appropriate measures to address the potential conflicts of interests, if the undertaking decides to add additional tasks or activities to the tasks and activities of the actuarial function.
- 1.78. In accordance to Article 246 of Solvency II, the national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level requires that the actuarial function gives in addition an opinion on the reinsurance policy and the reinsurance program for the group as a whole.

### **Guideline 41 - Coordination of the calculation of technical provisions**

- 1.79. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking identifies any inconsistency with the requirements set out in Articles 76 to 85 of Solvency II for the calculation of technical provisions and implements corrections as appropriate.

### **Guideline 42 – Valuation models of technical provisions**

- 1.80. In accordance with Article 48 of Solvency II, national competent authorities

should ensure that the actuarial function of the undertaking provides that the key drivers of the undertaking's risks are reflected and appropriately addressed in the valuation models underlying the calculation of the technical provisions, as well as in the assumptions and methodologies applied.

- 1.81. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking also provides that the valuation models are stable with respect to small variations introduced in the parameters of these valuation models.

### **Guideline 43 – Data quality**

- 1.82. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking assesses the consistency of the internal and external data used in the calculation of technical provisions against the data quality standards as set in Solvency II and that the actuarial function provides recommendations, where relevant, on internal procedures to improve data quality so as to ensure that the undertaking is a position to comply with the related Solvency II requirement when implemented.
- 1.83. In accordance with Article 48 of Solvency II, national competent authorities should ensure that, if there are any differences amongst the technical provisions for different valuation dates, the undertaking ensures that the actuarial function presents an explanation for the deviations.

### **Guideline 44 – Testing against experience**

- 1.84. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking reports any material deviations of actual experience compared to the projected best estimate to the administrative, management or supervisory body. The report should identify the causes of the deviations and, where applicable, proposes changes in the assumptions and modifications that may be applied to the valuation model in order to improve the best estimate calculation.

### **Guideline 45 – Underwriting policy and reinsurance arrangements**

- 1.85. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking takes into consideration the interrelations between an undertaking's reinsurance arrangements, its underwriting policy and the technical provisions.

## **Guideline 46 – The actuarial function of an undertaking with an internal model under pre-application**

1.86. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of an undertaking contributes to specifying which risks are covered by the internal model, which is the subject of a pre-application, in particular with regard to the risks relating to the terms on which business is written and how dependencies between risks are derived. This opinion is based on a technical analysis and should reflect the experience and expertise of the function.

## **Guideline 47 - Annual internal report to the administrative, management or supervisory body**

1.87. In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking produces a written report to be submitted to the administrative, management or supervisory body, at least annually. The report should document all tasks that have been undertaken by the actuarial functions and their results, and clearly identifies any deficiencies and gives recommendations as to how such deficiencies could be remedied.

## **Chapter IX: Outsourcing**

### **Guideline 48 - Critical or important operational function**

1.88. In accordance with Article 49 of Solvency II, national competent authorities should ensure that the undertaking determines and documents whether the outsourced function is a critical or important function and on the basis of whether this function is essential to the operation of the undertaking as it would be unable to deliver its services to policyholders without the function.

### **Guideline 49 - Underwriting**

1.89. In accordance with Article 49 of Solvency II, national competent authorities should ensure that, when an insurance intermediary, who is not an employee of the undertaking, is given authority to underwrite business or settle claims in the name and on account of an insurance undertaking, the undertaking ensures that the activity of this intermediary is subject to the outsourcing requirements.

### **Guideline 50 - Intra-group outsourcing**

1.90. In accordance with Article 49 of Solvency II, national competent authorities should ensure that, if key functions are outsourced within the group, the entity responsible for fulfilling the governance requirements at group level

documents which functions relate to which legal entity and ensures that the performance of the key functions at the level of the undertaking is not impaired by such arrangements.

#### **Guideline 51 - Outsourcing written policy**

- 1.91. In accordance with Article 49 of Solvency II, national competent authorities should ensure that the undertaking that outsources or considers outsourcing covers in its policy the undertaking's processes and strategies for outsourcing from the inception to the end of the contract. This in particular includes:
- a. how a service provider of suitable quality is selected;
  - b. the details to be included in the written agreement with the service; and
  - c. business contingency plans, including exit strategies.

### **Section III: Group governance specific requirements**

#### **Guideline 52 - Entity responsible for the fulfilment of the group governance requirements**

- 1.92. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the parent insurance or reinsurance undertaking or insurance holding company identifies the undertaking responsible for fulfilling the governance requirements at group level and report it to the group supervisor.

#### **Guideline 53 - Responsibilities for setting internal governance requirements**

- 1.93. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level sets adequate internal governance requirements across the group appropriate to the structure, business and risks of the group and of its related entities, and considers the appropriate structure and organization for risk management at group level, setting a clear allocation of responsibilities between all entities of the group.
- 1.94. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level does not impair the responsibilities of the administrative, management or supervisory body of each entity in the group when setting up its own system of governance.



## **Guideline 54 – System of Governance at group level**

1.95. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level:

- a. has in place appropriate and effective tools, procedures and lines of responsibility and accountability enabling it to oversee and steer the functioning of the risk management and internal control systems at individual level;
- b. has in place reporting lines within the group and effective systems for ensuring information flows in the group bottom up and top-down as well;
- c. documents and informs all the entities in the insurance group about the tools used to identify measure, manage and control all risks to which the group is exposed; and
- d. takes into account the interests of all the entities belonging to the group and how these interests contribute to the common purpose of the group as a whole over the long term.

## **Guideline 55 - Risks with significant impact at group level**

1.96. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level considers in its the risk management system the risks both at individual and group level and their interdependencies. In particular the following risks may have an impact significantly different at group level :

- a. contagion risk, reputational risk and risks arising from intra-group transactions and risk concentrations at the group level;
- b. interdependencies between risks stemming from conducting business through different entities and in different jurisdictions;
- c. risks arising from third-country entities;
- d. risks arising from non-regulated entities; and
- e. risks arising from other regulated entities.

## **Guideline 56 - Group risk management**

1.97. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level supports in its risk management at the level of the group by appropriate processes and procedures to identify, measure, manage, monitor and report the risks that the group and each individual undertaking are or might be exposed to.

- 1.98. In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level ensures that the structure and organization of the group risk management does not impair the undertaking's legal ability to fulfil its legal, regulatory and contractual obligations.

#### **Guideline 57 – Group internal model**

- 1.99. In accordance to Articles 120 to 126, 231 and 246 of Solvency II, through the pre-application process for a group internal model under Article 231 of Solvency II, national competent authorities should form a view on how all the undertakings that would use the group internal model for their SCR calculation ensure that there would be no constraints to comply with the tests and standards required by Solvency II for internal model use. In particular they ensure that there would be no constraints for an appropriate understanding of the group internal model as required by the use test provisions.

#### **Compliance and Reporting Rules**

- 1.100. This document contains Guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16(3) of the EIOPA Regulation, Competent Authorities shall make every effort to comply with guidelines and recommendations.
- 1.101. Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.
- 1.102. Competent authorities shall confirm to EIOPA whether they comply or intend to comply with these Guidelines, with reasons for non-compliance, by [dd mm yyyy].
- 1.103. In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting.

## 2. Annex I – Impact Assessment

### Preliminary analysis of the opportunity of issuing preparatory Guidelines

- 2.1. Before analysing pros and cons of the proposed groups of Guidelines with respect to the baseline, it is necessary, on a logical basis, to justify the choice of issuing preparatory Guidelines now or not doing anything and wait till the application of Solvency II.
- 2.2. For this null option it is possible to identify the following costs and benefits:

#### **Option 0, not issuing preparatory Guidelines:**

- 2.3. With regard to costs on the side of undertakings:
  - a) Potential compliance costs may arise in case undertakings start doing investments, purchasing systems and implementing processes based on the current version of L2 Implementing Measures, which may need to be changed later due to changes in the on-going political negotiations;
  - b) In the absence of Guidelines, practices may evolve differently with respect to other financial market sectors, provoking adjustment costs later (EBA issued guidelines in 2012 and IAIS have issued "Core Principles on Governance");
  - c) Another source of costs could be the final rushing to set up systems right before the implementation date of Solvency II. During the rushing errors are also easier to happen.
- 2.4. With regard to costs on the side of national competent authorities:
  - a) Some member states have started implementing parts of good governance; this bears the risks of future costs in order to be consistent with European requirements in the future;
  - b) In the absence of Guidelines, supervisory practices may evolve differently with respect to other financial market sectors, provoking adjustment costs later (EBA issued guidelines in 2012 and IAIS have issued "Core Principles on Governance");
  - c) Another source of costs could be the necessity to supervise undertaking during the final rushing right before the implementation date of Solvency II. During the rushing errors are also easier to happen.
  - d) The national competent authorities need to have enough resources and knowledge available for supervising insurance undertakings with regard to their system of governance. The preparatory period is a good opportunity for NCA, to build up this competence.
- 2.5. With regard to benefits on the side of undertakings:
  - a) The advantage for the industry could be that, in structuring its system of governance, undertakings have not to take into account any new aspects or further elements encompassed by these Guidelines.
  - b) In fact some member states might not have required fulfilling any measures with regard to governance.
  - c) However, one can argue if that (not having guiding principles) is really an advantage.

- 2.6. With regard to benefits on the side of national competent authorities:
- a) The advantage for NCAs could be that they do not have to take into account new aspects or further elements in the process of supervision the compliance by undertakings.
  - b) However, one can argue if that (not having guiding principles) is really an advantage.
- 2.7. For consumers:
- a) No immediate advantage as any costs that may be reflected on policyholders would also happen with full preparation of Solvency II.
  - b) The financial crisis in 2008 has shown that some risks with negative consequences for policyholders had their source in bad and insufficient governance structures within insurance undertakings. An enhanced system in the undertaking therefore protects policyholders, which is a good reason for issuing preparatory Guidelines.
- 2.8. The balancing between cons and pros led to the final evaluation that is beneficial for all providing now preparatory Guidelines, to help undertakings and national competent authorities in taking decisions and organising during the preparation phase.

## **1: Procedural issues and consultation of interested parties**

- 2.9. The Impact assessment was prepared in the course of the policy drafting process, with the contribution of experts on system of governance from different national competent authorities and EIOPA.
- 2.10. Selected stakeholders were pre-consulted in the preparation of the Guidelines.

## **2: Problem definition**

- 2.11. Existing Supervisory requirements with regard to the system of governance vary widely across Member States. These differing requirements do not provide a level playing field and for undertakings that are part of cross-border groups or has cross-border branches. Therefore, new requirements should harmonise and streamline supervisory requirements with regard to the system of governance in order to enhance transparency across borders.
- 2.12. Based on the economic crises it became evident that there was a need to strengthen and improve the requirements for the system of governance to ensure a more consistent and harmonised approach and to raise governance standards. Focus will be on how undertakings should manage their processes and procedures, including systems and controls to ensure continuous compliance with legislation and capital requirements.
- 2.13. The "Opinion of EIOPA on interim guidelines regarding Solvency II", issued on the 20th December 2012, stresses the importance of having a consistent and convergent approach with respect to the preparation of Solvency II. In the run-up of the new system, some key areas of Solvency II need to be addressed in order to ensure proper management of undertakings and to

ensure that supervisors have sufficient information at hand. The system of governance is among these key areas. This area of Guidelines aims at guiding undertakings in their preparation for the future phasing in of Solvency II.

## **Proportionality**

- 2.14. National competent authorities are expected to ensure that the provisions described in the Opinion are applied 'in a manner which is proportionate to the nature, scale and complexity inherent in the business of the insurance and reinsurance undertaking'. The approach taken aims to ensure that this expectation can be met, and this is reflected in the drafting of the Guidelines in two principal ways:
- 2.15. In most cases, the Guidelines are principle based or drafted with a view to the outcome or supervisory objective that should be met;
- 2.16. The level of detail and scope of the Guidelines reflects the fact that the Guidelines are issued in order to prepare for Solvency II and not for its full application.
- 2.17. For the overall approach to proportionality on the guidelines under consultation, please see the "Cover note for the Consultation Paper on Guidelines on preparing for Solvency II".

## **Baseline Scenario**

- 2.18. When analysing the impact from policies, the methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional public intervention. For the analysis of the potential related costs and benefits of the proposed guidelines, EIOPA has applied as a baseline the current practice, that means Solvency I requirements plus any national legislation on top of it (including any possible preparation that has already been made for implementing Solvency II, as well as eventual provisions set out in the CEIOPS' Level 3 Guidance).

## **3: Objective pursued**

- 2.19. The aim of the preparatory Guidelines on the system of governance is to provide guidance to undertakings to prepare for the phasing of requirements about the system of governance stated in the future Solvency II regime.
- 2.20. In the "Opinion of EIOPA on interim guidelines regarding Solvency II", system of governance is cited among the key areas in the preparation for future Solvency II. Moreover, the Opinion asks national competent authorities to start preparing appropriate procedures and tools to ensure that undertakings have in place an effective system of governance which provides for sound and prudent management.

- 2.21. When assessing the merits of the various policy options and approaches the aim is to deliver a system that addresses the weaknesses of the current regime, in particular with respect to removing obstacles to the proper functioning of the single market, whilst achieving an appropriate balance between the objectives of enhancing the protection of policyholders and beneficiaries and improving the international competitiveness of EU insurers and reinsurers.

### **3: Policy options**

- 2.22. In the light of the specific characteristics of these Guidelines, it was agreed to describe policy options not Guideline by Guideline neither group by group of Guidelines, but to proceed by themes. In fact, the Guidelines are all strictly linked and interrelated, and analysing them one by one would have ended up in a too fragmented and partial description. After discussion, it has been judged more appropriate to present directly policy options EIOPA considered, and then offer motivations about the preferred final choice. This way of constructing the reasoning appeared more adherent to the goals at the basis of system of governance.
- 2.23. EIOPA has identified five options that were considered in the development of the preparatory Guidelines. The identified options are based on what EIOPA believes could have the most significant impact on undertakings and the level of protection of policyholders as well as beneficiaries. The focal point of the options identified is how an underlying problem could evolve, all things being equal, if such options were not decided upon.
- 2.24. It is also worth highlighting that against the baseline the proposed preparatory Guidelines should not create material new requirements for undertakings in general. Instead, they give guidance as well as steering on what would be expected from the undertakings by national supervisors. Hence, for undertakings to comply with the preparatory Guidelines no additional incremental costs are envisaged.

#### **Whether to specify the difference between, and terminology of, risk tolerance and risk appetite**

- 2.25. EIOPA discussed whether to neither define nor clarify the terminology of risk tolerance and risk appetite at all since the terms are widely used and are understood differently within the financial sector or perhaps just to define characteristics of the terms used but not give definitions to ensure some basis for a common understanding. Finally it was discussed whether to prescribe a Solvency II definition of the terms to ensure a harmonised understanding between members and to ensure a common approach when reading the preparatory Guidelines.

#### **Whether to develop Guidelines on Prudent Person Principle as part of the System of Governance for the interim period**

- 2.26. Based on Article 132 of Solvency II, EIOPA discussed whether to include Guidelines on the Prudent Person Principle (PPP) as part of the System of Governance on account of the reference to PPP in Article 44 of Solvency II, or to leave it out for the preparatory period.

### **Whether to include minimum requirements on the use of derivatives in the preparatory Guidelines**

- 2.27. Article 44 of Solvency II requires that the risk management system of an undertaking cover among other things investments, in particular derivatives and similar commitments. The prudent person principle in Article 132 of Solvency II requires that undertakings only invest in assets whose risks can be properly identified, measured, monitored, managed and reported. Paragraph 4 of that Article also sets out some specific requirements on the use of derivatives. EIOPA discussed whether the requirements within Solvency II addressing the use of investments, including the above articles, should be complemented by further guidelines that specifically addressed requirements relevant to the use of derivatives by undertakings.

### **Whether to require combined annual information from the Actuarial Function to the AMSB or leave it up to the undertaking to decide how and when the information is to be provided**

- 2.28. According to Article 48(1) of Solvency II the Actuarial Function has to inform the AMSB about several subjects regarding the coordination or calculation of technical provisions. However, this does not include requirements on how this should be conducted. Hence, it was discussed whether the Actuarial Function has to provide to the AMSB combined information on an annual basis on all relevant issues or if the information should be provided whenever deemed necessary.

### **Whether or not to have extended notification requirements during the preparatory period**

- 2.29. According to Article 42(2) of Solvency II the notification requirements for persons subject to fit & proper requirements will apply to persons effectively running the undertaking and persons responsible for a key function. Existing notification requirements on national level usually apply to persons belonging to the AMSB or parts of it. Hence, the question was raised whether to require that additional persons, e.g. person responsible for key functions, should be notified to the supervisory authority during the preparatory period.

## **4: Analysis of impacts**

- 2.30. As a consequence of the choice of describing options not Guideline by Guideline, nor group by group of Guidelines, but by theme, it was agreed to give to this chapter a structure symmetric to the structure of the previous chapter. For each option, arguments are constructed to prepare the selection of the preferred one. In the next chapter, these pros and cons are compared in order to arrive to the final choice. For each preferred option,



the next chapter will summarise pros and cons for all actors involved, with the breakdown for undertakings, supervisors and policy holders.

- 2.31. In the Solvency II project, policy-makers have already considered, analysed and compared a number of policy options. Based on the impact assessment already done for the requirements set in Solvency II EIOPA has considered a wide range of policy options referring to the preparatory Guidelines. In this section EIOPA would like to show alternative options which were considered and preferred options that have been analysed seriously, and to explain why they were not pursued.
- 2.32. During the analysis, the principle of proportionality was always taken into account, as the Community actions should not go beyond what is necessary to achieve satisfactorily the objectives which have been set. Due to their size and scarce resources, small and medium sized undertakings (SMEs) can be affected by the costs of regulations more than their bigger competitors. At the same time, the benefits of regulations tend to be more evenly distributed over entities of different sizes. SMEs may have limited scope for benefiting from economies of scale. SMEs in general find it more difficult to access capital and as a result the cost of capital for them is often higher than for larger businesses. Therefore, the principle of proportionality was always taken into account while considering different options.

### **Whether to specify the difference between and terminology of risk tolerance and risk appetite**

- 2.33. When drafting the risk management section of the preparatory Guidelines on the system of governance, it was extensively discussed whether to specify the difference between risk tolerance and risk appetite.
- 2.34. The use of the terms is very diverse, and EIOPA discussed whether a Solvency II definition would ensure a common understanding of the meaning of the terms for the purpose of compliance with requirements and ensure a harmonised approach between supervisors. However, the Solvency II terminology could diverge from the undertaking's view of how the terms are to be understood. Furthermore use of the terms with different meanings within the undertaking for internal and regulatory purposes could lead to mistakes and unnecessary risk exposure.
- 2.35. Another option discussed was for EIOPA to respect the use of the terms as currently employed by undertakings while ensuring that for the purpose of compliance with regulatory requirements there is no ambiguity as to what is meant by the terms. This would still require the necessity for discussions between undertakings and supervisors to verify that the terms are used as understood under Solvency II and not as internally used and defined by the undertaking itself.
- 2.36. The last option discussed was for EIOPA not to try and define the terms nor clarify the terminologies at all which would give the undertakings the



possibility of not changing their current definitions of risk tolerance and risk appetite. This option though, would give the undertakings considerable uncertainties with regard to compliance with requirements as set out in Solvency II or the preparatory Guidelines. Additionally, it would also entail lack of harmonisation between national competent authorities in understanding the terms and could make the communication between undertakings and supervisors more difficult as there is not necessarily a common understanding as to the meaning and usage of the terms.

### **Whether to develop Guidelines on Prudent Person Principle as part of the System of Governance for the preparatory period**

- 2.37. The Prudent Person Principle (PPP) is defined in art. 132 of Solvency II but it is closely linked and explicitly mentioned in Article 44 of Solvency II, it was discussed whether preparatory Guidelines were needed to specify the requirements and supervisory expectations of this Article and whether the development of preparatory Guidelines should be a part of the system of governance.
- 2.38. The reasoning for choosing the option to include PPP in the interim period, although Article 132 of Solvency II is relative to Pillar I requirements, is that its application has to be firmly embedded within the undertaking's system of governance. EIOPA believes that undertakings could use the preparatory period to put in place a risk framework in which to test the application of PPP in respect of the undertakings investment policy taking into account the fact that the regulatory quantitative limits will no longer apply under Solvency II. Moreover, the definition and regulation of PPP in Solvency II is fairly short and high-level and being aware of, that these requirements encompass substantial responsibilities for undertakings, the lack of guidance would be particularly challenging for undertakings and supervisors alike.
- 2.39. If EIOPA did not develop preparatory Guidelines this would give undertakings more flexibility in how to interpret Article 132 of Solvency II. Furthermore, the principle as such - as opposed to its application to insurance undertakings - is not new. Undertakings could fall back on general explanations and understandings of the principle and hence, might not need guidance beyond what is already written. This would also limit the compliance costs, but could give more uncertainty on how to apply the PPP.

### **Whether to include minimum requirements on derivatives as part of the preparatory Guidelines**

- 2.40. Derivatives pose a substantial risk to the solvency of undertakings when they are mismanaged and embody particular risks which to a large extent are unique in relation to other asset categories, such as the exposure that goes beyond the principal (amount) invested.
- 2.41. If EIOPA were not to specifically address requirements relevant to the governance of derivatives within these Guidelines, it would provide

undertakings with greater discretion to determine what governance practices were necessary for the use of such instruments in relation to their risk profile. Conversely, by EIOPA developing preparatory Guidelines undertakings would get more information on the minimum requirements national competent authorities would expect them to comply with in the use of such instruments. Hence, the Guidelines would also encompass descriptions of some specific, but important aspects to ensure compliance with governance requirements when investing in derivatives.

- 2.42. Article 44 of Solvency II requires the risk-management system to at least cover the governance/control of investments and in particular derivatives and other commitments since these are not fully included in the calculation of the solvency capital requirement. Furthermore, article 132 of Solvency II already states that an undertaking need to identify, measure, monitor, manage, control and report all risks adherent to assets. Thus, knowing that undertakings would be assessed according to certain expectations whether they are set out in Guidelines or not, while still keeping in mind those minimum requirements specifically for certain investments, could put obstacles in the way of using derivatives. Consequently, this could create additional costs for undertakings with regard to organisation of processes and procedures (internal controls and documentation).

**Whether to require combined annual information from the actuarial function to the AMSB or leave it up to the undertaking to decide how and when the information is to be provided**

- 2.43. When discussing the actuarial function and the level of information to be provided to the AMSB that should be expected it was further discussed whether to require combined annual information from the actuarial function or just to require annual information on different subjects whenever they are available.
- 2.44. If the actuarial function has to prepare combined annual information covering all the issues to be reported to the AMSB this would ensure a higher level of harmonization among Member States concerning the frequency and the content of the information likely to be achieved. Furthermore, having a single document covering all the relevant issues concerning the tasks the actuarial function is responsible for, implies that all the relevant information is concentrated, but comprehensive.
- 2.45. Hence, there is less risk of missing information in this reporting process. It is also easier for the AMSB to identify the main problems and have the full picture of the different tasks performed and conclusions obtained as well as allowing for an easier way to see how technical provisions affect the assessment of the overall underwriting policy and the adequacy of the reinsurance arrangements. A consequence of the AMSB only receiving combined annual information is that it does not necessarily get the most

critical information when the information is needed in order to take this into account in its decision-making process.

- 2.46. Alternatively, consideration was given to the fact that the actuarial function could report during the year and encompass all relevant issues when they arise. This would enhance the possibility of having a more continuous reporting process along the year, making it easier to identify the problems at an earlier stage and give the undertaking a higher level of flexibility in the reporting process.
- 2.47. Additionally, this could more effectively involve the AMSB during the process of calculation and validation of technical provisions. Therefore, it gives the AMSB the option of challenging the analysis carried out. Hence, the reporting can be done nearer to the performance of the task and may be of better quality on this account (more details and better pros and cons when an assessment is fresh in mind).
- 2.48. A drawback to the annual separate reporting is the risk that providing parts of the information at different points in time could make it more difficult to see the entire picture for the AMSB and other potential recipients and lead to bad decision-making based on a deficient/inadequate basis.

#### **Whether or not to have extended notification requirements during the preparatory period**

- 2.49. As these Guidelines are based on the assumption that the qualitative requirements set out in Solvency II are already applicable, EIOPA could have proceeded with giving guidance on notification of persons effectively running the undertaking and responsible for key functions. While this would introduce better scrutiny it would however add considerable administrative burdens on both undertakings and supervisory authorities.
- 2.50. Having a postponement of the notification requirement could give an undertaking more leeway in testing whether a person really has the right qualifications for being a person appointed responsible for a key function. Furthermore, the undertaking would be able to more clearly define the tasks and responsibilities for the person responsible for the key function considering the undertaking's specific business model and clearly define in its processes and procedures what is expected of the key function and the person responsible for the key function.
- 2.51. On the other hand not having the notification requirement in place during the preparatory period, could make both supervisory authorities and undertakings less familiar with the notification process. Additionally, there could be a risk that the undertaking within the preparatory period has appointed a person that does not fulfil the fit and proper requirements from the time when Solvency II is fully implemented.

- 2.52. The requirement set out in Article 42(3) of Solvency II will only apply during the preparatory period for persons already subject to notification requirements on national level.

## **5: Comparing the options**

- 2.53. EIOPA believes that the proposed policy options help achieve the objectives pursued in enhancing the protection of policyholders and beneficiaries and improving the international competitiveness of EU insurers and reinsurers, in an efficient and effective way. A specific characteristic of the policy options proposed, and which contributes to an effective and efficient result, is that they allow for supervisory practices to be applied in a proportionate manner with respect to a risk based approach.
- 2.54. EIOPA appreciates that issuing these Guidelines may have an economic impact on undertakings. However, the benefits of having a common understanding of the requirements for the system of governance from the application of Solvency II between undertakings and supervisors are a vital step to ensure a level playing field and the much needed transparency. By keeping the incremental costs of issuing preparatory Guidelines in mind the options were extensively discussed and pros and cons were compared in order to find the best solution.
- 2.55. For the option of determining whether EIOPA should make a Solvency II definition of differences between the terms “risk tolerance” and “risk appetite” in order to align the use of these terms on the European level EIOPA discussions were based on the necessity of streamlining the terms. The pro would be a common approach to the use of the terms which would make comparisons. The con, however, is that the terms are not new within the financial sector and many undertakings already apply them on a daily basis.
- 2.56. Accordingly, EIOPA decided that instead of giving a Solvency II definition and specify the differences of the terms risk tolerance and risk appetite it would facilitate discussions and understandings between supervisors and undertakings in the long run if characteristics were provided alongside building blocks for the undertakings to decide for themselves how to apply the terms. This ensures that supervisors and undertakings are equally responsible for reaching a common understanding of the use of the terms and limit misunderstandings.
- 2.57. When discussing the necessity of developing preparatory Guidelines on PPP as part of the system of governance EIOPA decided that since the application of the principle for insurance undertakings is a requirement in Solvency II without any quantifiable thresholds for investments there is a strong link to the risk management system. Accordingly, the development of a separate set of Guidelines was discarded on account of the reference in

Article 44 of Solvency II and the significant link between risk management and investment policies.

- 2.58. Further, EIOPA received remarks from stakeholders during consultations and informal suggestions that some stakeholders were unsure what the principle entails. E.g. PPP does not mean “anything goes”. In order to ensure and promote a common understanding among supervisors and undertakings as to what the principle and its requirements are, EIOPA developed these Guidelines. The Guidelines cover investment risk management, assessment of non-routine investment activities, investments in unit-linked and index-linked contracts and finally on the use of securitised assets and assets not admitted for trading on a regulated market to ensure a minimum level of harmonisation and understanding of the principle as well as the close link to risk management. The expectation is that undertakings should use the preparatory period to familiarise themselves with the application of the PPP and how it can be embedded in the investment policy.
- 2.59. In a similar context the option of developing Guidelines on the use of derivatives was discussed. Knowing that undertakings would be assessed according to certain expectations regarding the use of derivatives whether they are set out in Guidelines or not, and taking into account that new requirements could put obstacles in the way of using derivatives and create additional costs for undertakings with regard to organisation of processes and procedures (internal controls and documentation), EIOPA found that providing Guidelines would meet the objectives of Solvency II more effectively and efficiently and provide for a better understanding of allocation of capital resources.
- 2.60. Furthermore, by ensuring a more common understanding of the use of derivatives and the risks they impose, undertakings could enhance policyholder protection while improving the international competitiveness of the insurance sector due to a common basis for investment strategies and better capital management.
- 2.61. Accordingly, EIOPA decided that Guidelines should be developed to ensure focus on the increased use of derivatives by undertakings but be kept to a minimum to ensure the flexibility as provided by the PPP. Guidance on how to handle investments in derivatives focuses on the importance of this issue being addressed in the policy on risk management and that undertaking can demonstrate and document how derivatives are used to contribute to a reduction of risks or as risk mitigation technique.
- 2.62. The same flexibility applied to the option on whether to require combined annual information or just separate reporting on relevant issues from the actuarial function to the AMSB. According to the system of governance requirements, the AMSB must ensure that information regarding the undertaking’s risks are generated and communicated to the individuals who need to see it. If reports are to be done at different times and

communicated to different people the AMSB must consider the resulting impact upon the relevance, coherence and timeliness of information reporting within the organization to ensure clear processes and procedures in order to limit misunderstandings.

- 2.63. Nevertheless, since reporting processes and procedures are undertaking specific, EIOPA decided to leave the responsibility to undertakings for determining what reporting process and procedures fits the undertaking's specific business structure. Hence, EIOPA decided to leave it to the undertakings to decide how they wish to receive the information required in order to fit their reporting needs. Accordingly, the Guidelines only require that the AMSB receives at least an annual internal report documenting the tasks undergone by the actuarial function, the results and the identification of any deficiencies identified and how these can be remedied. Concerning option 6, regarding the notification requirement during the preparatory period, EIOPA decided that requiring a notification according to Article 42 (2) of Solvency II for persons responsible for a key function would be too onerous to apply. However, undertakings are still responsible for conducting their own internal fit & proper assessment of people appointed during the preparatory period and ensuring that the appointed persons meet the requirements as set out in Article 42 of Solvency II when Solvency II is applicable.

## **5: Concluding remarks**

- 2.64. The cost and benefits of introducing preparatory Guidelines can be summarised in the following breakdown:

### **Undertakings**

- 2.65. Additional costs for undertakings can be valued on a minor scale compared to those introduced by Solvency II:
- a) Specifying certain terms used in Solvency II, like risk tolerance and risk appetite, does not affect costs when applying the preparatory Guidelines;
  - b) The prudent person principle is already introduced in Solvency II and by including it in the preparatory Guidelines the specification on how to apply the principle facilitates the use of the principle for undertakings as it clarifies supervisory expectations;
  - c) The minimum requirements that govern the use of derivatives also help undertakings to better understand what is required of them when engaging in the use of derivatives as part of their investment strategy. Furthermore, this will prepare the undertakings for the increased scrutiny by the supervisory authorities when Solvency II is fully applied and the quantitative regulatory limits are replaced by the prudent person principle;
  - d) EIOPA has left it up to undertakings to decide whether they want the actuarial function to submit combined annual information or submitting it as required by the AMSB. This leaves more discretion to undertakings without increasing costs and gives them the possibility to implement the solution most appropriate for their purposes;



- e) The postponement of the notification requirement will not increase costs for the undertakings during the preparatory period. Nevertheless, they still have to assess internally whether a person is fit and proper which is a requirement imposed by Solvency II and not added by the preparatory Guidelines;

2.66. Undertakings would gain benefits from the preparatory Guidelines:

- a) They still leave undertakings with the freedom to organise themselves as they think is appropriate while making some of the principles and requirements clearer in order to facilitate compliance with Solvency II requirements;
- b) The preparatory Guidelines give the basis for a common European understanding for all undertakings about the relevance and requirements of governance, thus strengthening the soundness and transparency of the market and promoting good practices across Member States;
- c) Since they clarify supervisory expectations, they can facilitate the communication between undertakings and supervisory authorities, helping undertakings to avoid the possible costs of revisions following a supervisory review;
- d) They are designed to assist the industry in putting in place and testing the adequacy of new system of governance in preparation for the full implementation of the Solvency II regime.

## **Supervisory Authorities**

2.67. From the perspective of the supervisory authorities, the largest part of costs related to the System of Governance requirements arises directly from Solvency II. Nevertheless, there are some costs related to the preparatory Guidelines where the undertaking has the freedom to decide what is best for them. This entails the necessity for supervisory authorities of making sure that they understand each undertaking's specific way of doing business in terms of how they are organised, how they define their investment strategy and how they apply terms not defined by Solvency II.

2.68. However, supervisory authorities will also benefit from the interaction needed since it gives them a better insight into how the undertakings work in practice.

## **Policyholders**

2.69. The indirect costs of introducing preparatory Guidelines on the system of governance could, at least to some extent, be transferred from undertakings to policyholders, depending on the market conditions prevailing in each Member State. However, EIOPA believes that no direct costs are expected for policyholders stemming directly from these Guidelines. Policyholders will benefit from the sounder governance and higher level of transparency associated with the preparatory Guidelines that ensures better policyholder protection.

2.70. EIOPA believes that the application of the proposed Guidelines as well as characteristics of terms ensures a harmonised and comparable basis for

undertakings' risk and capital management as well as for the risk-based supervisory assessment. Moreover, EIOPA is convinced that the application of these Guidelines will ensure common understanding and a level playing field within the internal market.