

Consultation Paper on the proposal for Guidelines on system of governance and own risks and solvency assessment

The Guidelines at hand have already been extensively consulted for the purpose of the preparatory phase. The preparatory Guidelines, herewith converted into Guidelines for application from 1 January 2016 onwards, have only undergone limited changes. The current document highlights (in yellow) the elements that have not been subject to the preparatory Guidelines issued in 2013 and which are therefore new.

Stakeholders are invited to focus their comments on the highlighted text.

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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 and Own Risk and Solvency Assessment.

Comments are most helpful if they:

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

Please send your comments to EIOPA in the single Template for Comments provided for the Set 1 of the Solvency II Guidelines to the address Consultation_GLset1_SII@eiopa.europa.eu by 29 August 2014.

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

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.

Please note that a request to access confidential responses may be submitted in accordance with EIOPA's rules on public access to documents¹. 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 under the heading 'Legal notice'.

¹ [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)

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 presents the draft Guidelines on System of Governance and the draft Guidelines on Own Risk and Solvency Assessment and their corresponding explanatory texts.

The analysis of the expected impact from the proposed policy is covered under the Impact Assessment, which is available in EIOPA's website.

Next steps

EIOPA will consider the feedback received and expects to publish a final report on the consultation. The final Guidelines are subject to adoption by the Board of Supervisors of EIOPA.

I. Guidelines on System of Governance

1. Guidelines

Introduction

- 1.1. According to Article 16 of Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (hereinafter "EIOPA Regulation")², EIOPA issues these Guidelines addressed to the supervisory authorities on how to proceed with the application 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 (hereinafter "Solvency II")³.
- 1.2. These Guidelines are based on Articles 40 to 49, Article 93, Article 132 and Article 246 of Solvency II.
- 1.3. The requirements on the system of governance are aimed at providing for sound and prudent management of the business of undertakings without unduly restricting them in choosing their own organisational structure, as long as they establish an appropriate segregation of duties.
- 1.4. At least the four functions included in the system of governance, namely the risk management, the compliance, the actuarial and the internal audit function, are considered to be key functions and consequently also important or critical functions. Furthermore, persons are considered to be persons having key functions if they perform functions of specific importance for the undertaking in view of its business and organisation. These additional key functions, if any, are identified by the undertaking, but the determination of whether such functions should be considered key or not may be challenged by the supervisory authority. The notification requirements apply to persons effectively running the undertaking or being key function holders. The latter means the person who is responsible for a key function. In case of outsourcing of a key function, the function holder is the person who has the oversight over the outsourcing at the undertaking.
- 1.5. These Guidelines provide further details on a number of issues regarding remuneration policy, including the composition of the remuneration committee.
- 1.6. The fit and proper requirements apply to all persons who effectively run the undertaking or have other key functions in order to ensure that all the persons holding relevant functions in the undertaking are appropriately qualified. The scope of the requirements aims to avoid gaps where important persons for the undertaking are not covered, accepting at the same time that there may well be considerable overlap between persons from senior management who are considered to effectively run the undertaking and other key function holders.
- 1.7. The notification requirements only apply to persons who effectively run the undertaking or are key function holders as opposed to persons who have or perform a key function. In case of outsourcing of a key function or of

² OJ L 331, 15.12.2010, p. 48–83.

³ OJ L 335, 17.12.2009, p.1-155.

outsourcing of a part of a function where this part is regarded as key, the person responsible is considered to be the one who has the oversight over the outsourcing at the undertaking.

- 1.8. The Guidelines on risk management takes as a starting point that an adequate risk management system requires an effective and efficient set of integrated measures which must fit into the organisation and operational activity of the undertaking. There is no single risk management system that is appropriate to all undertakings; the system must be tailored to the individual undertaking.
- 1.9. Although the own risk and solvency assessment (hereinafter "ORSA") is part of the risk management system, the corresponding Guidelines are set out separately.
- 1.10. While internal models are mentioned in connection with the responsibilities of the risk management function, on the whole, the Guidelines on the system of governance do not address specific internal model related issues.
- 1.11. Article 132 of Solvency II introduces the 'prudent person principle' which determines how undertakings should invest their assets. The absence of regulatory limits on investments does not mean that undertakings can take investment decisions without any regard to prudence and to the interests of policyholders. The requirements of Solvency II and of the draft implementing measures cover extensively some of the main aspects of the prudent person principle, such as asset-liability management, investment in derivatives, liquidity risk management and concentration risk management. Therefore, the intention of these Guidelines is not to further develop these aspects, but to focus on the remaining aspects of the prudent person principle.
- 1.12. With respect to the actuarial function, these Guidelines focus on what should be done by the actuarial function, rather than how it should be performed. As the purpose of having the actuarial function is to provide a measure of quality assurance through expert technical actuarial advice, it is especially important to establish specific technical guidance on the tasks, responsibilities and other aspects of the actuarial function.
- 1.13. Currently, the institution of the "responsible/appointed actuary" exists in some Member States. As the "responsible/appointed actuary" is not foreseen by Solvency II, it is up to the supervisory authorities concerned to decide on whether to keep the "responsible/appointed actuary" or not, and how it relates to the actuarial function. However, this issue is not addressed under these Guidelines.
- 1.14. The Guidelines on outsourcing are based on the principle that an undertaking has to ensure that it remains fully responsible for discharging all its obligations when outsourcing any function or activities. In particular, there are strict and rigorous measures an undertaking must meet if it outsources a critical or important function or activity. In particular, an undertaking has to give proper consideration to the content of the written agreement with the service provider.
- 1.15. Intra-group outsourcing is not necessarily different from external outsourcing. It may allow for a less stringent selection process, but it should not to be seen as automatically requiring less care and oversight than external outsourcing.

- 1.16. The Guidelines apply to both individual undertakings and *mutatis mutandis* at the level of the group. Additionally, for groups the group specific Guidelines apply.
- 1.17. The implementation of governance requirements at group level should be understood as having in place a robust governance system applied to one coherent economic entity (holistic view) comprising all entities in the group.
- 1.18. The governance requirements at group level take into account the corporate governance responsibilities of both, the administrative, management or supervisory body at group level, that is, the administrative, management or supervisory body of the entity responsible for the fulfilment of the requirements, and the administrative, management or supervisory body of legal entities that belong to the group.
- 1.19. For the purpose of these Guidelines, the following definition has been developed:
- 'the responsible entity' is the entity responsible for fulfilling the governance requirements at group level;
 - persons who effectively run the undertaking cover members of the administrative, management or supervisory body taking into account national law, as well as members of the senior management. The latter includes persons employed by the undertaking who are responsible for high level decision making and for implementing the strategies devised and the policies approved by the administrative, management or supervisory body;
 - persons having other key functions include all persons performing tasks related to a key function;
 - key function holders' are the persons responsible for a key function as opposed to persons having, carrying out or performing a key function.
- 1.20. If not defined in these Guidelines the terms have the meaning defined in the legal acts referred to in the introduction.
- 1.21. The Guidelines shall apply from 1 January 2016.

Chapter I: System of governance

Section 1: General governance requirements

Guideline 1 - The administrative, management or supervisory body

- 1.22. The administrative, management or supervisory body (hereinafter "AMSB") should have appropriate interaction with any committee it establishes, as well as with senior management and with persons having other key functions in the undertaking, proactively requesting information from them and challenging that information when necessary.
- 1.23. At group level the AMSB of the responsible entity should have an appropriate interaction with the AMSB of all entities within the group, requesting information proactively and challenging the decisions in the matters that may affect the group.

Guideline 2 – Organisational and operational structure

- 1.24. The undertaking should have 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.
- 1.25. The AMSB of the responsible entity of a group should assess how changes to the group's structure impact on the sustainable financial position of the entities affected and makes the necessary adjustments in a timely manner.
- 1.26. The AMSB of the responsible entity of a group should, in order to take appropriate measures, have an appropriate knowledge of the corporate organisation of the group, the business model of its different entities and the links and relationships between them and the risks arising from the group's structure.

Guideline 3 – Decision-making

- 1.27. The undertaking should ensure that any significant decision of the undertaking involves at least two persons who effectively run the undertaking before the decision is being implemented.

Guideline 4 - Documentation of decisions taken at the level of the AMSB

- 1.28. The undertaking should appropriately document the decisions taken at the level of the AMSB of the undertaking and how information from the risk management system has been taken into account.

Guideline 5 - Allocation and segregation of duties and responsibilities

- 1.29. The undertaking should ensure that the duties and responsibilities are allocated, segregated and coordinated in line with the undertaking's policies and reflected in descriptions of tasks and responsibilities avoiding unnecessary overlaps. The undertaking should ensure that all the important duties are covered and that

unnecessary overlaps are avoided. Effective cooperation between personnel should be fostered.

1.30. At group level the entity responsible for fulfilling the governance requirements should ensure that the mechanisms of coordination of the functions within the group are clearly defined.

Guideline 6 - Internal review of the system of governance

1.31. The AMSB of the undertaking should determine 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.

1.32. The undertaking should ensure that the scope, findings and conclusions of the review are properly documented and reported to its AMSB. Suitable feedback loops are necessary to ensure follow-up actions are undertaken and recorded.

Guideline 7 – Policies

1.33. The undertaking should align all policies required as part of the system of governance with each other and with its business strategy. Each policy should clearly set out at least:

- a) the goals pursued by the policy;
- a) the tasks to be performed and the person or role responsible for them;
- b) the processes and reporting procedures to be applied;
- c) 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.

1.34. In the policies that cover the key functions, the undertaking should also address the position of these functions within the undertaking, their rights and powers.

1.35. The responsible entity should ensure that the policies are implemented consistently across the group. In addition, it ensures that the policies of the entities of the group are consistent with the group policies.

Guideline 8 - Contingency plans

1.36. The undertaking should identify risks to be addressed by contingency plans covering the areas where it considers itself to be vulnerable, and review, update and test these contingency plans on a regular basis.

Section 2: Remuneration

Guideline 9 - Scope of the remuneration policy

1.37. The undertaking should ensure in its remuneration policy that:

- a) remuneration arrangements with service providers do not encourage risk-taking that is excessive in view of the undertaking's risk management strategy;
- b) remuneration awards do not threaten the undertaking's ability to maintain an adequate capital base.

1.38. The responsible entity should adopt and implement a remuneration policy for the whole group. This should take into account the complexity and structures of the group in order to establish, develop and implement a consistent policy for the whole group that is in line with the group's risk management strategies. The policy should be applied to all relevant persons at group and individual entity level.

1.39. The responsible entity should ensure:

- a) an overall consistency of the group's remuneration policies by ensuring that they comply with the requirements of the entities which are part of the group and by verifying their correct application;
- b) that all the entities that belong to the group comply with the remuneration requirements.

Guideline 10 - Remuneration committee

1.40. The undertaking should ensure that the composition of the remuneration committee enables it to exercise a competent and independent judgment on the remuneration policy and its oversight. If no remuneration committee is established, the AMSB should assume the tasks that would otherwise have been assigned to a remuneration committee in a way that it avoids conflicts of interest.

Section 3: Fit and proper

Guideline 11 – Fit requirements

1.41. The undertaking should ensure that persons who effectively run the undertaking or have other key functions are 'fit' and take account of the respective duties allocated to individual persons to ensure appropriate diversity of qualifications, knowledge and relevant experience so that the undertaking is managed and overseen in a professional manner.

1.42. The AMSB should collectively possess appropriate qualification, experience and knowledge about at least:

- a) insurance and financial markets;
- b) business strategy and business model;
- c) system of governance;
- d) financial and actuarial analysis;
- e) regulatory framework and requirements.

Guideline 12 - Proper requirements

1.43. When assessing whether a person is 'proper', the undertaking should consider that the period of limitation of the committed offence is judged based on national law.

Guideline 13 - Fit and proper policies and procedures

1.44. The undertaking should have a policy on the fit and proper requirements, which includes at least:

- a) a description of the procedure for notifying the supervisory authority for the cases where notification is required;
- b) 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;
- c) a description of the situations that give rise to a re-assessment of the fit and proper requirements;
- d) 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

1.45. The undertaking should apply the fit and proper procedures in assessing persons employed by the service provider or sub service provider to perform an outsourced key function.

1.46. The undertaking should designate 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. This designated person is the person responsible for the key function according to Article 42 (2) of Solvency II that needs to be notified to the supervisory authority.

Guideline 15 - Notification

1.47. The supervisory authority should require as a minimum from the undertaking the information included in the Technical Annex to be submitted by means of a notification.

Guideline 16 - Assessment of the fit and proper requirements by the supervisory authority

1.48. The supervisory authority should assess the fit and proper requirements of the persons subject to notification requirements and give feedback on this to the undertaking concerned within an appropriate timeframe from the receipt of a complete notification.

Section 4: Risk management

Guideline 17 - Role of the AMSB in the risk management system

1.49. The AMSB of the undertaking should be 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.

1.50. The AMSB of the responsible entity should ensure that the risk management system of the whole group is effective. This risk management system of the group 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;
- c) the identification, measurement, management, monitoring and reporting of risks at group level.

1.51. The responsible entity should ensure that such strategic decisions and policies are consistent with the group's structure, size and the specificities of the entities in the group. It also should ensure that the specific operations, which are material, and associated risks of each entity in the group are covered. In addition, it should ensure that an integrated, consistent and efficient risk management of the group is put in place.

Guideline 18 - Risk management policy

1.52. The undertaking should establish 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, area of risks and any potential aggregation of risks;
- c) describes the connection with the overall solvency needs assessment as identified in the ORSA, the regulatory capital requirements and the undertaking's overall risk tolerance limits;
- d) specifies risk tolerance limits within all relevant risk categories in line with the undertaking's risk appetite;
- e) describes the frequency and content of regular stress tests and the situations that would warrant ad-hoc stress tests.

Guideline 19 - Risk management function: general tasks

1.53. The undertaking should require the risk management function to report to the AMSB 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 AMSB.

Guideline 20 - Underwriting and reserving risk management policy

1.54. In its risk management policy, the undertaking should cover at least the following with regard to underwriting and reserving risk:

- a) the types and characteristics of the insurance business, such as 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 process of designing a new insurance product and the premium calculation, the undertaking takes account of the constraints related to investments;
- e) how, in the process of designing a new insurance product and the premium calculation, the undertaking takes account of reinsurance or other risk mitigation techniques.

Guideline 21 – Operational risk management policy

1.55. In the risk management policy, the undertaking should cover at least the following with regard to operational risk:

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

1.56. The undertaking should have processes to identify, analyse and report on operational risk events. For this purpose, it should establish a process for collecting and monitoring operational risk events.

1.57. For the purposes of operational risk management, the undertaking should develop and analyse an appropriate set of operational risk scenarios based on at least the following approaches:

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

Guideline 22 – Control and documentation of risk-mitigation techniques

1.58. For the purposes of proper use of reinsurance and other risk mitigation techniques the undertaking should

- a) analyse, assess and document the effectiveness of all risk mitigation techniques employed;
- b) document the extent to which its risk mitigation recognised in the calculation of the Solvency Capital Requirement meets the requirements defined in the risk-mitigation techniques section of the draft implementing measures.

Guideline 23 - Reinsurance and other risk-mitigation techniques – risk management policy

1.59. In the risk management policy the undertaking should cover 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 tolerance limits and which kind of reinsurance arrangements are most appropriate considering the undertaking's risk profile;
- b) principles for the selection of such risk mitigation 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 procedures to deal with any timing mismatch between claims' payments and reinsurance recoverable.

Guideline 24 - Strategic and reputational risk

1.60. The undertaking should identify, assess and monitor the following situations:

- a) actual or potential exposure to reputational and strategic risks and the correlation between these risks and other material risks;
- b) key issues affecting its reputation, considering the expectations of stakeholders and the sensitivity of the market.

Guideline 25 - Asset-liability management policy

1.61. In its risk management policy the undertaking should cover 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;
- d) a description of the underlying methodology and frequency of stress tests and scenario tests to be carried out.

Guideline 26 - Investment risk management policy

1.62. In its risk management policy the undertaking should cover at least the following information 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) its quantitative limits on assets and exposures, including off-balance sheet exposures, that are to be established to help to ensure the undertaking achieves 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 adverse scenarios;
- f) the procedure for appropriately valuing and verifying the investment assets;
- g) the procedures to monitor the performance of the investments and review the policy when necessary;
- h) how the assets are to be selected in the best interest of policyholders and beneficiaries.

Guideline 27 - Liquidity risk management policy

1.63. In its risk management policy the undertaking should cover at least the following information 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) identification and costs of alternative financing tools;
- e) consideration of the effect on the liquidity situation of expected new business.

Section 5: The prudent person principle and the system of governance

Guideline 28 - Investment risk management

1.64. The undertaking should not solely depend on the information provided by third parties, such as financial institutions, asset managers and rating agencies. In particular, the undertaking should develop its own set of key risk indicators in line with its investment risk management policy and business strategy.

1.65. When 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 29 – Assessment of non-routine investment activities

1.66. Before performing any investment or investment activity of a non-routine nature the undertaking should carry 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 policyholders' interest, liability constraints set by the undertaking and efficient portfolio management;
- d) the impact of this investment or investment activity on the quality, security, liquidity, profitability and availability of the whole portfolio.

1.67. The undertaking should have procedures that require that where such 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 AMSB of the undertaking.

Guideline 30 – Security of the investment portfolios

1.68. The undertaking should regularly assess the security of the investment portfolios by considering at least:

- a) the characteristics that justify, guarantee or affect the value of the assets with regard to events that could potentially change these characteristics;
- b) the diversification of the assets.

Guideline 31 - Profitability

1.69. The undertaking should determine the returns it seeks from its investments taking into account the need to obtain a sustainable yield on the asset portfolios, security and liquidity requirements, as well as the capital market situation.

1.70. When considering the profitability of assets, the undertaking should take into account any interest rate guarantee, and any disclosed policy on future discretionary benefits and reasonable policyholders' expectations.

Guideline 32 - Availability

1.71. When assessing the availability of assets the undertaking should not limit this to localisation. The undertaking should determine how frequently this assessment should be performed.

Guideline 33 - Conflicts of interests

1.72. The undertaking should describe in its investment policy how it identifies and manages any conflicts of interest that arise regarding investments, irrespective of whether they arise in the undertaking or in the entity which manages the asset portfolio. It should also document the actions taken to manage such conflicts.

Guideline 34 - Unit-linked and index-linked contracts

1.73. The undertaking should ensure that its investments of unit-linked and index-linked contracts are selected in the best interest of policyholders and beneficiaries taking into account any disclosed policy objectives.

1.74. In the case of unit-linked business the undertaking should take into account and manage the constraints related to unit-linked contracts, in particular liquidity constraints.

Guideline 35 - Assets not admitted for trading on a regulated financial market

1.75. The undertaking should implement, manage, monitor and control 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.

1.76. The undertaking should treat 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 36 - Derivatives

1.77. When using derivatives, the undertaking should implement the procedures in line with its investment risk management policy to monitor the performance of these derivatives.

1.78. The undertaking should demonstrate how the quality, security, liquidity or profitability of the portfolio is improved without significant impairment of any of these features where derivatives are used to facilitate efficient portfolio management.

1.79. The undertaking should document the rationale and demonstrate 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 37 - Securitised instruments

1.80. Where the undertaking invests in securitised instruments, it should ensure that its interests and the interests of the originator or sponsor concerning the securitised assets are well understood and aligned.

Section 6: Own fund requirements and the system of governance

Guideline 38 – Capital management policy

1.81. The undertaking develop a capital management policy which includes a description of the procedures to:

- a) ensure that own fund items, both at issue and subsequently, are classified according to the features in [Articles 59, 61, 63, 65, and 67] of the draft implementing measures;
- b) monitor tier by tier the issuance of own fund items according to the medium term capital management plan, and ensure before issuance of any own fund item that it satisfies the criteria for the appropriate tier on a continuous basis;
- c) monitor that own funds items are not encumbered by the existence of any agreements or connected transactions, or as a consequence of a group structure, which would undermine their efficacy as capital;

- d) ensure that the actions required or permitted under the contractual, statutory or legal provisions governing an item are initiated and completed in a timely manner;
- e) ensure that ancillary own fund items can be and are called in a timely manner when necessary;
- f) ensure that any arrangement, legislation or products that give rise to ring-fenced funds are identified and documented and appropriate calculations and adjustments in the determination of the SCR and own funds;
- g) ensure that the terms and conditions of any own fund item are clear and unambiguous in relation to the criteria;
- h) ensure that any policy or statement in respect of ordinary share dividends is taken into account in consideration of the capital position;
- i) identify and document instances in which distributions on an own funds item are expected to be deferred or cancelled;
- j) ensure that the extent to which the undertaking relies on own fund items subject to transitional provisions and the manner in which these operate in times of stress, and in particular how the items absorb losses, are identified and assessed and, if necessary, taken into account in the ORSA.

Guideline 39 – Medium-term capital management plan

- 1.82. The undertaking should develop a medium-term capital management plan which is to be monitored by the AMSB 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) the result of the projections made in the ORSA;
 - d) how any issuance, redemption or repayment of, or other variation in the valuation of an own funds item affects the application of the limits on tiers;
 - e) the application of the distribution policy;
 - f) the impact of the end of the transitional period.

Guideline 40 – Distributions

- 1.83. With regard to distributions made on own funds items the undertaking should include in its capital management policy a description of the procedure to:
- a) ensure that any policy or statement in respect of ordinary share dividends is fully taken into account in the assessment of foreseeable dividends;
 - b) identify and document the instances in which distributions on tier 1 items might be cancelled on a discretionary basis;

- c) identify, document and enforce the instances in which distributions on an own funds item will be cancelled or deferred.

Section 7: Internal controls

Guideline 41 – Internal control environment

- 1.84. The undertaking should promote 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.
- 1.85. The responsible entity should ensure a consistent implementation of the internal control systems across the group.

Guideline 42 – Monitoring and reporting

- 1.86. The undertaking should establish monitoring and reporting mechanisms within the internal control system which provide the AMSB with the relevant information for the decision-making processes.

Section 8: Internal audit function

Guideline 43 – Independence

- 1.87. When performing an audit and when evaluating and reporting the audit results, the undertaking should ensure that the internal audit function is not subject to influence from the AMSB that can impair its operational independence and impartiality.

Guideline 44 – Conflicts of interest within the internal audit function

- 1.88. In order to mitigate the risk of any conflicts of interest, the undertaking should rotate staff assignments within the internal audit function regularly.
- 1.89. The undertaking should ensure that internally recruited auditors do not audit activities or functions they previously performed during the timeframe covered by the audit.

Guideline 45 - Internal audit policy

- 1.90. The undertaking should have 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) where appropriate, internal rules setting out the procedures the person responsible for the internal audit function needs to follow before informing the supervisory authority;
 - c) where appropriate, the criteria for the rotation of staff assignments.
- 1.91. The responsible entity should ensure that the internal audit policy at the level of the group describes how the internal audit function:

- a) coordinates the internal audit activity across the group;
- b) ensures compliance with the internal audit requirements at the group level.

Guideline 46 – Internal audit plan

1.92. The undertaking should ensure that the internal audit plan:

- a) is based on a methodical risk analysis, taking into account all the activities and the complete system of governance, as well as expected developments of activities and innovations;
- b) covers all significant activities that are to be reviewed within a reasonable period of time.

Guideline 47 - Internal audit documentation

1.93. The undertaking should keep a record of the work of the internal audit function, including the work documented in working papers.

1.94. In order to allow for an assessment of the effectiveness of the work of the internal audit function, undertakings should document the audits in a way that allows for retracing the audits undertaken and the findings they produced.

Guideline 48 – Internal audit function tasks

1.95. The undertaking should require that the internal audit function, in the report to the AMSB, includes the envisaged period of time to remedy the shortcomings, and information on the achievement of previous audit recommendations.

Section 9: Actuarial function

Guideline 49 - Tasks of the actuarial function

1.96. The undertaking should take 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.

1.97. The responsible entity should require that the actuarial function gives an opinion on the reinsurance policy and the reinsurance program for the group as a whole.

Guideline 50 - Coordination of the calculation of technical provisions

1.98. The undertaking should require the actuarial function to identify any inconsistency with the requirements set out in Articles 76 to Article 85 of Solvency II for the calculation of technical provisions and propose corrections as appropriate.

1.99. The undertaking should require the actuarial function to explain any material effect of changes in data, methodologies or assumptions between valuation dates on the amount of technical provisions.

Guideline 51 – Data quality

1.100. The undertaking should require the actuarial function to assess 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. Where relevant, the

actuarial function provides recommendations on internal procedures to improve data quality so as to ensure that the undertaking is in a position to comply with Solvency II requirements.

Guideline 52 – Testing against experience

1.101. The undertaking should ensure that the actuarial function reports any material deviations from actual experience to the projected best estimate to the AMSB. The report should identify the causes of the deviations and, where applicable, propose changes in the assumptions and modifications to the valuation model in order to improve the best estimate calculation.

Guideline 53 – Underwriting policy and reinsurance arrangements

1.102. The undertaking should require the actuarial function, when providing its opinion on the underwriting policy and the reinsurance arrangements, to take into consideration the interrelations between these and the technical provisions.

Guideline 54 – The actuarial function of an undertaking using an internal model

1.103. The undertaking should require the actuarial function to contribute to specifying which risks within their domain of expertise are covered by the internal model. The actuarial function should also contribute to how dependencies between these risks and dependencies between these risks and other risks are derived. This contribution is based on a technical analysis and should reflect the experience and expertise of the function.

Guideline 55 - Actuarial reporting to the AMSB

1.104. The undertaking should require the actuarial function to report in writing at least annually to the AMSB. The reporting should document all material tasks that have been undertaken by the actuarial functions, their results, clearly identifying any deficiencies and giving recommendations as to how such deficiencies could be remedied.

Section 10: Valuation of assets and liabilities other than technical provisions

Guideline 56 - Valuation of assets and liabilities other than technical provisions

1.105. The undertaking should include in the policies for valuation of assets and liabilities procedures, at least:

- a) the assessment of active and non-active markets;
- b) the model designs and their implementation;
- c) the adequacy of inputs, for example data, parameters and assumptions;
- d) the steps followed during the process of the valuation;
- e) the models' performance;

- f) an independent review and verification;
- g) the regular reporting to the AMSB.

Guideline 57 – Data quality control procedures

1.106. The undertaking should implement data quality control procedures to identify deficiencies and to measure, monitor, manage and document their data quality. These procedures should include:

- a) completeness of data;
- b) appropriateness of data, both from internal and external sources;
- c) independent review and verification of data quality.

1.107. The policies and procedures implemented by the undertaking should address the need to periodically review market data and inputs against alternative sources and experience.

Guideline 58 – Documentation of the review process

1.108. The undertaking should provide adequate documentation in which the different inputs and steps in the valuation process are recorded.

Guideline 59 – Documentation when using alternative valuation methods

1.109. Where alternative methods for valuation are used, the undertaking should document:

- a) a description of the method, purpose, key assumptions, limitations and output;
- b) the circumstances under which the method would not work effectively;
- c) description and analysis of the valuation process, and the controls linked with the method;
- d) an analysis of valuation uncertainty linked with the method;
- e) a description of back-testing procedures performed on the results and, where possible, a comparison against comparable models or other benchmarks, which should be carried out when the valuation method is first introduced and regularly thereafter;
- f) a description of the tools or programs used.

Guideline 60 - Independent review and verification of valuation methods

1.110. The undertaking should ensure that an independent review of the valuation method, following [Article 257bis (4)(b)] takes place before the implementation of a new method or a major change, and on a regular basis thereafter.

1.111. The undertaking should determine the frequency of the review in line with the significance of the method for the decision-making and risk management processes.

1.112. The undertaking should apply the same principles for the independent review and verification of both internally developed valuation methods or models and for vendor provided valuation methods or models.

1.113. The undertaking should have processes in place to report the results of the independent review and verification, as well as the recommendations for remedial actions to the appropriate management level of the undertaking.

Guideline 61 - Oversight by the AMSB

1.114. The undertaking should ensure that the AMSB and other persons who effectively run the undertaking are able to demonstrate an overall understanding of the valuation approaches and the uncertainties involved in the valuation process to allow a proper oversight of the risk management process concerning valuation.

Guideline 62 – Request to the undertaking by the supervisory authority for an external independent valuation or verification

1.115. The supervisory authority should consider requesting an independent valuation or verification from the undertaking at least when there is a risk of misstatements in the valuation of material assets or liabilities, with possible material consequences for the undertaking's solvency situation.

Guideline 63 – Independence of the external expert

1.116. The undertaking should be able to demonstrate to the supervisory authority that the external valuation or verification has been performed by independent experts with the relevant professional competence, due care and relevant experience.

Guideline 64 – Information to be provided to the supervisory authority on the external valuation or verification

1.117. The undertaking should provide the supervisory authority with all relevant information requested on external valuation or verification. The undertaking should include in this information, at least, the experts' written opinion on the valuation of the relevant asset or liability.

Section 11: Outsourcing

Guideline 65 - Critical or important operational functions and activities

1.118. The undertaking should determine and document whether the outsourced function or activity is a critical or important function or activity on the basis of whether this function or activity is essential to the operation of the undertaking as it would be unable to deliver its services to policyholders without the function or activity.

Guideline 66 - Underwriting

1.119. 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 should ensure that the activity of this intermediary is subject to the outsourcing requirements.

Guideline 67 - Intra-group outsourcing

1.120.If key functions are outsourced within the group, the responsible entity should document which functions relate to which legal entity and ensure that the performance of the key functions at the level of the undertaking is not impaired by such arrangements.

Guideline 68 - Outsourcing written policy

1.121.The undertaking that outsources or considers outsourcing should cover in its policy the undertaking's approach and processes for outsourcing from the inception to the end of the contract. This in particular should include:

- a) the criteria for determining whether a function or activity is critical or important;
- b) how a service provider of suitable quality is selected and how and how often his performance and results are assessed;
- c) the details to be included in the written agreement with the service provider taking into consideration the requirements laid down in the draft implementing measures;
- d) business contingency plans, including exit strategies for outsourced critical or important functions or activities.

Guideline 69 - Written notification to the supervisory authority

1.122.The undertaking should describe in its written notification to the supervisory authority of any outsourcing of critical or important functions or activities and the service provider's name. When outsourcing concerns a key function, the notification should also include the name of the person in charge of the outsourced function or activities at the service provider.

Chapter II: Group governance specific requirements

Guideline 70 – Responsible entity

1.123.The participating insurance or reinsurance undertaking or the insurance holding company should identify the responsible entity, which is able to implement the governance requirements across the group, and report it to the group supervisor.

Guideline 71 – Responsibilities for setting internal governance requirements

1.124.The responsible entity should set adequate internal governance requirements across the group appropriate to the structure, business and risks of the group and of its related entities, and should consider the appropriate structure and organization for risk management at group level, setting a clear allocation of responsibilities between all entities of the group.

1.125.The responsible entity should not impair the responsibilities of the AMSB of each entity in the group when setting up its own system of governance.

Guideline 72 – System of governance at group level

1.126.The responsible entity should:

- a) have 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) have 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) document and inform all the entities in the group about the tools used to identify, measure, monitor, manage and report all risks to which the group is exposed;
- d) take 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 73 – Risks with significant impact at group level

1.127. The responsible entity should consider in its risk management system the risks both at individual and group level and their interdependencies, in particular:

- a) reputational risk and risks arising from intra-group transactions and risk concentrations, including contagion risk, 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;
- e) risks arising from other regulated entities.

Guideline 74 – Concentration risk at group level

1.128. The responsible entity should ensure that there are processes and procedures in place to avoid concentration risks that may be a threat at group level.

Guideline 75 - Intra-group transactions

1.129. The responsible entity should ensure that the risk management system of the group and the individual undertakings include processes and reporting procedures for identifying, measuring, monitoring, managing and reporting of intra-group transactions, including significant and very significant intra-group transactions as referred in Solvency II.

Guideline 76 – Group risk management

1.130. The responsible entity should support 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 entity are or might be exposed to.

1.131. The responsible entity should ensure that the structure and organization of the group risk management do not impair the undertaking's legal ability to fulfil its legal, regulatory and contractual obligations.

Guideline 77 – Centralised risk management

1.132. Where centralised risk management is implemented:

- a) the responsible entity should define and document how and to what extent it carries out the centralised risk management function for another entity of the group;
- b) the undertaking that transfers material tasks related to its risk management function should remain responsible for these tasks;
- c) the responsible entity and the undertaking should put in place processes and procedures that allow the undertaking to receive appropriate information with regard to its risk management responsibilities and that allows the undertaking to send to the responsible entity information necessary to perform an appropriate centralised risk management.

Technical Annex: Minimum information to be provided to the supervisory authority concerning the fit & proper assessment

Contact information

- Name of the undertaking
- Undertaking's registration number
- Contact person:
 - a) First name
 - b) Surname
 - c) Title
 - d) Telephone number
 - e) E-mail address
 - f) Fax number

Fact being notified

- First appointment
- Change in previous information
- Change of position

Description of the position being notified

- Name of the position
- Scope of the responsibilities
- Date of the appointment
- Length of appointment, if applicable
- Executive functions or not
- Any other information the undertaking deems relevant for the assessment

Information on the person subject to notification

- First name
- Surname
- Any previous names
- Personal address
- Telephone number
- Date of birth
- Place of birth
- Nationality
- Information on any previous assessment/notification process by a supervisory authority of the financial sector within the EEA:
 - a) Name of the supervisory authority
 - b) Country
 - c) Date
- Information on previous employments, qualified assignments or appointments as a member of an administrative, management or supervisory body:

- a) Company name and registration number
- b) Nature and scope of the operations
- c) The registered office of the undertaking
- d) Position
- Any other positions held:
 - a) Company name and registration number
 - b) Nature and scope of the operations
 - c) The registered office of the undertaking
 - d) Position
- Description of the level of knowledge, competence and experience of the person to perform the task, including:
 - a) Skills, knowledge (university degree, training or diploma)
 - b) Professional relevant experience
- Information on potential conflicts of interest with details, if applicable
Qualifying ownership or any other form of substantial influence in the undertaking
- Any other companies in which the notified person has a direct or indirect qualifying ownership:
 - a) Company name and registration number
 - b) Nature and scope of the operations
 - c) The registered office of the company
 - d) Possession in percentage
- Close relatives with ownership shares in the undertaking that notifies or in any other company which has ownership shares in that company
- Close relatives with any other financial relations to companies mentioned above
- Any other commitments that may give rise to conflict of interest with explanations as to the circumstances and a statement how the notified person intends to deal with potential conflicts of interest
- Conviction in a domestic or foreign court within the last X years [number of years according to national law] with explanation of circumstances, if applicable
- Pending criminal proceedings
- Membership in a board of directors in an operating undertaking that has not been granted a release from liability
- Dismissal from a position in a financial institution, company or from employment as a senior executive or termination of an engagement as a board member or auditor in another operating undertaking
- Participation in an arbitration board
- Bankruptcies or the equivalent abroad
- Rejection of an application, exclusion or limitation in any other way in terms of the right to conduct operations or a profession which requires authorisation, registration or such of the competent authority, organisation or equivalent body
- Supervisory sanctions against the person notified or a company where the person had a key function
- Any other information relevant to the assessment by the supervisory authority

Documents to be submitted

- Extract from the judicial record or an equivalent document issued by a competent judicial or administrative authority.

Declarations

- Declaration signed by the appropriately authorized person [according to national law/practice the management or supervisory body or the person responsible for this in the undertaking with the position of the person(s) in the undertaking given] that the assessment was performed in accordance with the laws, regulations and undertaking's fit and proper policy and the person subject to notification was considered as fit and proper for the job
- Declaration that the information submitted in the notification is correct and complete: date, name of signatories in block letters, signatures

2. Explanatory text on Guidelines on system of governance

Guideline 1 - The administrative, management or supervisory body

The administrative, management or supervisory body (hereinafter "AMSB") should have appropriate interaction with any committee it establishes as well as with senior management and with persons having other key functions in the undertaking, proactively requesting information from them and challenging that information when necessary.

At group level the AMSB of the responsible entity should have an appropriate interaction with the AMSB of all entities within the group, requesting information proactively and challenging the decisions in the matters that may affect the group.

- 2.1 The focal point of the governance system is the AMSB. The term "administrative, management or supervisory body" used in Solvency II – which in these Guidelines is shortened to the term "AMSB" - covers the single board in a one-tier system and either the management or the supervisory board of a two-tier board system depending on their responsibilities and duties. When transposing Solvency II, each Member State considers its own specificities and attributes responsibilities and duties to the appropriate board, if necessary.
- 2.2 An undertaking's AMSB is expected to consider whether a committee structure is appropriate and, if so, what its mandate and reporting lines should be. For example, it could consider forming audit, risk, investment or remuneration committees.

Guideline 2 – Organisational and operational structure

The undertaking should have 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.

The AMSB of the responsible entity of a group should assess how changes to the group's structure impact on the sustainable financial position of the entities affected and makes the necessary adjustments in a timely manner.

The AMSB of the responsible entity of a group should, in order to take appropriate measures, have an appropriate knowledge of the corporate organisation of the group, the business model of its different entities and the links and relationships between them and the risks arising from the group's structure.

- 2.3 Sound and prudent management of the business implies among other things a consistent application of risk management and internal control practices throughout the entire organisational structure of the undertaking. In order to support this goal, consideration ought to be given to drawing up and implementing a code of conduct for all staff, including the AMSB and senior management. Apart from the general code of conduct, everybody in the undertaking also has to be familiar with more detailed codes applicable to their own areas of expertise.
- 2.4 It is important that the undertaking ensures that it has an organisational culture that enables and supports the effective operation of its system of

governance. This requires an appropriate “tone at the top” with the AMSB and senior management providing appropriate organisational values and priorities.

- 2.5 The undertaking needs to ensure that each key function has an appropriate standing within the organisational structure. This requires that their responsibilities and the authority they have to exercise their tasks are clearly set out.
- 2.6 The operational structure supports the main functions of the organisational structure. It identifies the business processes involving material risks and sets out how they should be executed, including responsibilities and information flows, to ensure that these processes are adequately monitored and controlled.
- 2.7 The undertaking has to document its internal organisational and operational structures and keep this documentation up to date and keep them for an appropriate time frame, taking into account prescribed record retention periods.
- 2.8 The assessment of the appropriateness of the organisational and operational structure is required both at individual and group level. Inquiries addressed by the group supervisor, in cooperation with the college of supervisors, on the appropriateness of the organizational and operational structure may be expected where changes occur in the group’s structures, as well as on interconnections and significant transactions between group entities.

Guideline 3 – Decision-making

The undertaking should ensure that any significant decision of the undertaking involves at least two persons who effectively run the undertaking before the decision is being implemented.

- 2.9 Significant decisions as opposed to day-to-day decisions do not concern the spate of usual decisions to be taken at the top level of the undertaking in the running of the business, but are rather decisions that are unusual or that will or could have a material impact on the undertaking. This could be e.g. decisions that affect the strategy of the undertaking, its business activities or its business conduct, that could have serious legal or regulatory consequences, that could have major financial effects or major implications for staff or policyholders or that could potentially result in repercussions for the undertaking’s reputation.

Guideline 5 - Allocation and segregation of duties and responsibilities

The undertaking should ensure that the duties and responsibilities are allocated, segregated and coordinated in line with the undertaking’s policies and reflected in descriptions of tasks and responsibilities avoiding unnecessary overlaps. The undertaking should ensure that all the important duties are covered and that unnecessary overlaps are avoided. Effective cooperation between personnel should be fostered.

At group level the entity responsible for fulfilling the governance requirements should ensure that the mechanisms of coordination of the functions within the group

are clearly defined.

- 2.10 An adequate segregation of responsibilities ensures that the persons performing tasks are not simultaneously also responsible for monitoring and controlling the adequacy of this performance.
- 2.11 In principle, incompatible functions, i.e. tasks if performed by the same persons could give rise to conflicts of interest. These tasks have to be clearly separated and not be performed by the same person or persons. This separation needs to be observed on all levels of the undertaking, including the AMSB.
- 2.12 All key functions explicitly mentioned in the Directive have to be operationally independent. This means key functions have to retain the responsibility for taking the decisions necessary for the proper performance of their duties without interference from others. This requires that the functions are integrated into the organisational structure in a way that ensures that there is no undue influence, control or constraint exercised on the functions with respect to the performance of their duties and responsibilities by other operational or key functions, senior management or the AMSB.
- 2.13 While it is not incompatible with operational independence for a person or unit to perform more than one key function, segregation of the responsibilities of the key functions as set out in the Directive is the most effective way to safeguard operational independence. Hence an undertaking that does not want to keep key functions separate from each other has to demonstrate that in view of its risk profile it is proportionate for it to do so and that it has effective processes and procedures in place to ensure that operational independence is not compromised.
- 2.14 The segregation of key functions does not automatically provide for operational independence and other measures may also be necessary.
- 2.15 Operational independence implies that the key functions are able to report their results and any concerns and suggestions for addressing these they may have directly to the AMSB without restrictions as to their scope or content from anybody else. This does not however preclude that the reports are subject to comments by relevant functions within the undertaking before they are passed on.
- 2.16 The AMSB is ultimately responsible for deciding how to react to the results, concerns and recommendations presented to it by the key functions. For example, it could resolve not to act or act differently from suggestions in the findings of a key function.
- 2.17 The AMSB does not exert influence to suppress or tone down key function results in order that there is no discrepancy between the findings of key functions and the AMSB's actions.
- 2.18 At group level the role and responsibilities of each undertaking in the group in respect to the group's overall strategic objectives and operations have also to be clearly defined in the group's policies.
- 2.19 A regulated undertaking in a group structure must follow its own governance responsibilities and set its own strategies and policies, consistently with group strategies and policies. Any group-level decisions or procedures have to be

evaluated to ensure that they do not put the individual entity in breach of applicable legal or regulatory provisions or prudential rules.

2.20 In order to ensure an effective system for providing the transmission of information in accordance with Article 41 (1) of Directive 2009/138/EC, second subparagraph, undertakings are required to introduce clear reporting lines that provide for the prompt transfer of information to all persons who need it.

Guideline 6 - Internal review of the system of governance

The AMSB of the undertaking should determine 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.

The undertaking should ensure that the scope, findings and conclusions of the review are properly documented and reported to its AMSB. Suitable feedback loops are necessary to ensure follow-up actions are undertaken and recorded.

2.21 The AMSB has to ensure that the system of governance is internally reviewed on a regular basis. The review undertaken by the internal audit function on the system of governance as part of its responsibilities can provide input to this internal review.

2.22 The feedback procedures need to encompass at least all key functions and include a review of the system of governance with recommendations for revisions where necessary. After the feedback reports are presented to the AMSB, discussions on any challenge provided or improvements suggested by the AMSB have to be appropriately documented.

Guideline 7 – Policies

The undertaking should align all policies required as part of the system of governance with each other and with its business strategy. Each policy 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;
- 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.

In the policies that cover the key functions, the undertaking should also address the position of these functions within the undertaking, their rights and powers.

The responsible entity should ensure that the policies are implemented consistently across the group. In addition, it ensures that the policies of the entities of the group are consistent with the group policies.

- 2.23 The undertaking may combine the written policies required by Solvency II as it sees fit in line with its organisational structure and processes.
- 2.24 Written policies are subject to prior approval by the AMSB not only for the original policy proposal but also for any subsequent changes, unless these are minor.
- 2.25 A proper implementation of the written policies requires ensuring that all relevant staff members are familiar with and observe the policies for their respective area of activities. It also requires that any changes to the policies are promptly communicated to them.
- 2.26 The review requirement applies to all written policies undertakings have to implement in order to comply with Solvency II, i.e. it not only covers the policies explicitly referred to in Article 41(3) but also e.g. the “sub-policies” according to Article 44(2), the ORSA policy, the Solvency and Financial Condition Report (SFCR) policy and the model change policy.
- 2.27 Any review of the written policies has to be appropriately documented. The documentation needs to record who conducted the review and to include any suggested recommendations and the decisions subsequently taken by the AMSB in respect of those recommendations as well as the reasons for them.

Guideline 8 - Contingency plans

The undertaking should identify risks to be addressed by contingency plans covering the areas where it considers itself to be vulnerable, and reviews, updates and tests these contingency plans on a regular basis.

- 2.28 The undertakings has to develop and document contingency plans to ensure that business disruption or possible losses are limited if there is an unforeseen interruption to its systems and procedures. These might for example arise from natural catastrophes such as floods or earthquakes, from terrorist attacks, serious fires, a breakdown of the IT systems or a pandemic that affects a large number of employees. The aim of contingency planning is to enable the undertaking to continue its business activity at a predetermined minimum level to protect individuals and tangible property as well as assets.
- 2.29 While it is not necessary that contingency planning includes every activity of the undertaking, it has to take into consideration all significant activities. Test runs provide assurance that the plans will actually work effectively should an emergency arise. The plans have to be made available to all relevant management and personnel so that every person involved knows their role in advance of any emergency situation.

2.30 The undertaking also has to give proper consideration to determining communication channels in case of emergencies.

Guideline 9 - Scope of the remuneration policy

The undertaking should ensure in its remuneration policy that:

- a) remuneration arrangements with service providers do not encourage risk-taking that is excessive in view of the undertaking's risk management strategy;
- b) remuneration awards do not threaten the undertaking's ability to maintain an adequate capital base.

The responsible entity should adopt and implement a remuneration policy for the whole group. This should take into account the complexity and structures of the group in order to establish, develop and implement a consistent policy for the whole group that is in line with the group's risk management strategies. The policy should be applied to all relevant persons at group and individual entity level.

The responsible entity should ensure:

- a) an overall consistency of the group's remuneration policies by ensuring that they comply with the requirements of the entities which are part of the group and by verifying their correct application;
- b) that all the entities that belong to the group comply with the remuneration requirements.

2.31 The existence of incentives to attract and retain competent, experienced and skilled human resources can be an essential part of an undertaking's business strategy. Remuneration policy not only helps ensure that an undertaking has staff with the necessary skills and qualifications, it can also provide incentives that align staff's decision-making and risk-taking behaviour with the undertaking's business objectives and risk management strategy.

2.32 Subject to limitations imposed by collective bargaining arrangements, statutorily determined amounts of redundancy payouts and other national legislation, termination payments will be structured so as to reflect the principles and performance criteria used for the compensation of the individual over the whole period of activity at the undertaking. In this way they will be better aligned with the objectives and implementation of other aspects of the remuneration policy, and avoid rewarding failure.

2.33 For the purpose of determining what constitutes "failure" in [Article 265 (2)f (12)], the remuneration policy will consider the overall assessment of an individual's performance, not just the performance of a particular business unit

or entity, including cases where the undertaking is facing or is likely to face a difficult or irregular situation that may affect its financial performance.

2.34 The overall design of the remuneration policy is expected to be aligned with:

- (a) the overall business strategy;
- (b) the risk policy and risk tolerance limits; and
- (c) the system of governance, including the management of conflicts of interest that may arise:
 - i. for the individuals establishing the remuneration policy and approving and reviewing the remuneration policy and remuneration contracts;
 - ii. for those remunerated for selling or underwriting significant new business that may affect the risk profile of the undertaking; and
 - iii. for asset managers.

2.35 The policy also includes the methodology for identifying staff that may have a material impact on the undertaking's risk profile.

2.36 Where variable remuneration is tied to an individual's performance, it needs to be based upon a balanced set of indicators which also include adherence to effective risk management and compliance. This will help ensure that remuneration incentives are aligned with an undertaking's overall business and risk management strategies and objectives.

2.37 The undertaking has to consider including as part of the review of the remuneration policy an assessment of whether the established practice(s) reaches its objectives. In particular, that all agreed plans or programs are being covered, that the remuneration pay-outs are appropriate and all current and future risks and uncertainties are taken into account; that the policy is not undermined by actions of the staff; and that the solvency position, risk profile, long-term objectives and goals of the undertaking are adequately reflected.

Guideline 10 - Remuneration committee

The undertaking should ensure that the composition of the remuneration committee enables it to exercise a competent and independent judgment on the remuneration policy and its oversight. If no remuneration committee is established, the AMSB should assume the tasks that would otherwise have been assigned to a remuneration committee in a way that it avoids conflicts of interest.

2.38 When determining whether a remuneration committee is required, an undertaking considers various factors, including the size, nature and scope of its business, its internal organisation and the resulting complexity of the remuneration policy and its link to the undertaking's risk profile.

2.39 The remuneration committee or the person designated to assume its tasks needs to have access to all the data and information necessary to advise on the design and maintenance of an effective remuneration policy. To secure proper

governance, the committee ensure proper involvement of the persons responsible for the key functions.

2.40 The tasks of the remuneration committee or the person designated to assume its tasks include, but are not be limited to:

- (a) supporting the AMSB on the design of the undertaking's overall remuneration policy;
- (b) preparation of decisions regarding remuneration;
- (c) reviewing the policy regularly to ensure it remains appropriate during changes to the undertaking's operations or business environment;
- (d) identifying potential conflicts of interest and the steps taken to address them; and
- (e) Providing adequate information to the AMSB regarding the performance of the remuneration policy.

Guideline 11 – Fit requirements

The undertaking should ensure that persons who effectively run the undertaking or have other key functions are 'fit' and take account of the respective duties allocated to individual persons to ensure appropriate diversity of qualifications, knowledge and relevant experience so that the undertaking is managed and overseen in a professional manner.

The AMSB should collectively possess appropriate qualification, experience and knowledge about at least:

- a) insurance and financial markets;
- b) business strategy and business model;
- c) system of governance;
- d) financial and actuarial analysis;
- e) regulatory framework and requirements.

2.41 The undertaking has to assess the fitness and propriety as set out in these Guidelines regarding all persons who effectively run the undertaking as well as all persons working within a key function. In addition, when the undertaking is appointing an individual to be responsible for a key function or effectively run the undertaking, they formally notify the supervisory authority and provide the information needed to assess whether the individual is fit and proper.

2.42 When assessing the knowledge, competence and experience required for the performance of a particular role within the AMSB, the qualifications and experience of other employees within the undertaking could be taken into account as a relevant factor.

- 2.43 The fitness assessment is not limited to the moment of employment but includes arranging for further professional training as necessary, so that staff is also able to meet changing or increasing requirements of their particular responsibilities.
- 2.44 The members of the AMSB are not each expected to possess expert knowledge, competence and experience within all areas of the undertaking. However, the collective knowledge, competence and experience of the AMSB as a whole have to provide for a sound and prudent management of the undertaking.
- 2.45 When changes occur within the AMSB, e.g. replacement of one of the members of the AMSB, the undertaking is expected to be able to demonstrate at all times that the collective knowledge of the members of the AMSB is maintained at an adequate level.
- 2.46 'Insurance and Financial Markets knowledge' means an awareness and understanding of the wider business, economic and market environment in which the undertaking operates and an awareness of the level of knowledge of and needs of policyholders.
- 2.47 'Business strategy and business model knowledge' refers to a detailed understanding of the undertaking's business strategy and model.
- 2.48 'System of Governance knowledge' means the awareness and understanding of the risks the undertaking is facing and the capability of managing them. Furthermore, it includes the ability to assess the effectiveness of the undertaking's arrangements to deliver effective governance, oversight and controls in the business and, if necessary, oversee changes in these areas.
- 2.49 'Financial and actuarial analysis knowledge' means the ability to interpret the undertaking's financial and actuarial information, identify key issues, put in place appropriate controls and take necessary measures based on this information.
- 2.50 'Regulatory framework and requirements knowledge' means awareness and understanding of the regulatory framework in which the undertaking operates, in terms of both the regulatory requirements and expectations, and the capacity to adapt to changes to the regulatory framework without delay.

Guideline 12 - Proper requirements

When assessing whether a person is 'proper', the undertaking should consider that the period of limitation of the committed offence is judged based on national law.

- 2.51 Relevant criminal offences include any offence under the laws governing banking, financial, securities or insurance activity, or concerning securities markets or securities or payment instruments, including, but not limited, to laws on money laundering, market manipulation, or insider dealing and usury as well as any offences of dishonesty such as fraud or financial crime. They also include any other criminal offences under legislation relating to companies, bankruptcy, insolvency, or consumer protection.
- 2.52 Any other criminal offences currently being tried or having been tried in the past may also be relevant, as they can cast doubt on the integrity of the person.

- 2.53 Relevant disciplinary or administrative offences include any offences made under an activity of the financial sector, including offences under legislation relating to companies, bankruptcy, insolvency, or consumer protection.
- 2.54 When assessing the propriety of the person other circumstances than court decisions and on-going judicial proceedings, which may cast doubt on the repute and integrity of the person, may also be considered. These could include current investigations or enforcement actions, the imposition of administrative sanctions for non-compliance with provisions governing banking, financial, securities or insurance activity, securities markets, securities or payment instruments or any financial services legislation.
- 2.55 Further, current investigations or enforcement actions by any relevant regulatory or professional body for non-compliance with any relevant provisions could be taken into account.
- 2.56 Notwithstanding what has been written, having previous infringements does not automatically result in the person not being assessed as proper for the duties he/she is to perform. It is recognised that, while criminal, disciplinary or administrative convictions or past misconduct are significant factors, the assessment of the fit and proper requirements is to be done on a case-by-case basis. Hence, consideration needs to be given to the type of misconduct or conviction, the level of appeal (definitive vs. non-definitive convictions), the lapse of time since the misconduct or conviction, and its severity, as well as the person's subsequent conduct.
- 2.57 All persons are expected to avoid, to the extent possible, activities that could create conflicts of interest or the appearance of conflicts of interest.
- 2.58 The proportionality principle does not result in different standards in the case of the propriety requirement, for persons who effectively run the undertaking or have other key functions, since the repute and integrity of the persons should always be on the same adequate level irrespective of the nature, scale and complexity of the risks inherent to the business or of the undertaking's risk profile.
- 2.59 Proper considerations are relevant for all employees of an undertaking. However, any assessment needs to take into account their level of responsibility within the undertaking and will differ proportionately, according to whether or not, for example, they are persons who effectively run the undertaking or have other key functions.

Guideline 13 - Fit and proper policies and procedures

The undertaking should have a policy on the fit and proper requirements, which includes at least:

- a) a description of the procedure for notifying the supervisory authority for the cases where notification is required;
- b) 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;

- c) a description of the situations that give rise to a re-assessment of the fit and proper requirements;
- d) 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.

2.60 The policy establishes which situations would imply a review of whether a person should still be regarded as fit and proper. At least the following situations are considered:

- a) when there are reasons to believe that a person will discourage the undertaking from pursuing the business in a way that is consistent with applicable legislation;
- b) when there are reasons to believe that a person will increase the risk of financial crime, e.g. money laundering or financing of terrorism; and
- c) when there are reasons to believe that sound and prudent management of the business of the undertaking is at risk.

Guideline 14 - Outsourcing of key functions

The undertaking should apply the fit and proper procedures in assessing persons employed by the service provider or sub service provider to perform an outsourced key function.

The undertaking should designate 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. This designated person is the person responsible for the key function according to Article 42 (2) of Solvency II that needs to be notified to the supervisory authority.

2.61 If an undertaking outsources a key function, the undertaking also needs to ensure the service provider has checked the fitness and propriety of all persons working on that function.

2.62 The fitness of the person with overall responsibility for the outsourced key function at the undertaking is assessed taking into account that, while the oversight role carries ultimate responsibility for the key function, the level of knowledge required would not need to be as in depth as that of the relevant person(s) at the service provider. But at a minimum the person with overall responsibility for the outsourced key function at the undertaking has to possess enough knowledge and experience regarding the outsourced key function to be able to challenge the performance and results of the service provider.

2.63 When outsourcing a key function, an undertaking also needs to consider all the other issues mentioned in the outsourcing Guidelines.

2.64 The undertaking is required to notify the supervisory authority:

- (a) of the positions that effectively run the undertaking with the analysis and reasons for selecting them and the names of the persons performing them;

- (b) the functions the undertaking considers key with the analysis and reasons for selecting them and the names of the persons responsible for them;
- (c) when changes occur regarding the positions and functions defined above based on new evaluations done by the undertaking;
- (d) when a person who effectively runs the undertaking or who is responsible for any key function is going to be or has been appointed (timing is dependent on national specific requirements); and
- (e) when a person who effectively runs the undertaking, or is responsible for a key function is replaced because the undertaking considers that the person no longer fulfils the fit and proper requirements.

2.65 The notification of the persons who effectively run the undertaking or key function holder is undertaken in writing and submitted to the supervisory authority without undue delay.

2.66 The undertaking is expected to supplement the information included in the Annex with any additional documents considered necessary to complement the information or required by the supervisory authority.

Guideline 15 - Notification

The supervisory authority should require as a minimum from the undertaking the information included in Technical Annex to be submitted by means of a notification.

2.67 In order to improve the harmonisation of supervisory practices, a minimum level of information is to be provided by undertakings for the purposes of fit and proper notifications. An undertaking also needs to provide the rationale for appointing or replacing the individual concerned. The form that the submission of information should take is left to Member States. The undertaking is expected to supplement the information included in the Annex with any additional documents considered necessary to complement the information or required by the supervisory authority. The fit and proper notification itself is complete when the supervisory authority has received all the information required (minimum information included in Annex) and any complementary documents and information; however, the supervisory authority may at any time during the assessment require additional information or explanations from the undertaking and if necessary, an interview is to be conducted with the individual.

Guideline 16 - Assessment of the fit and proper requirements by the supervisory authority

The supervisory authority should assess the fit and proper requirements of the persons subject to notification requirements and give feedback on this to the undertaking concerned within an appropriate timeframe from the receipt of a complete notification.

- 2.68 The appropriate assessment period and process will be determined by each supervisory authority. Feedback could be in the form that silence within a pre-defined period means no objection.
- 2.69 In cases where there has already been an assessment by other supervisory authorities, in the same or another jurisdiction, the supervisory authority concerned communicates with those supervisors as part of the assessment procedure.
- 2.70 The supervisor is expected to make appropriate use of information available from the appropriate law enforcement authorities. The supervisor may also check available records and databases, for example on institutions registered by the chamber of commerce and on bankruptcies.
- 2.71 On the basis of the information collected, the supervisor will assess if the person meets the fit and proper requirements. Where this information gives rise to doubts about the person's fitness and propriety, the supervisor will undertake further investigation. The assessment period and process will be dependent on each supervisory authority but nevertheless has to be conducted within an appropriate timeframe from the receipt of a complete application.
- 2.72 A person considered suitable for a particular position within an undertaking may not be suitable for another position with different responsibilities or for a similar position within another undertaking. Conversely, a person considered unsuitable for a particular position in a particular undertaking may be considered suitable under different circumstances.
- 2.73 Ultimately, if the supervisory authority concludes, with adequate justification, that the person to be appointed/already appointed does not comply with the relevant fit and proper requirements, the supervisory authority has the power to require the undertaking not to appoint, or to replace, the person in question. A supervisor is expected to reassess the fitness and propriety of an individual if facts, circumstances or actions give rise to such a measure.

Guideline 17 - Role of the AMSB in the risk management system

The AMSB of the undertaking should be 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.

The AMSB of the responsible entity should ensure that the risk management system of the whole group is effective. This risk management system of the group 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;
- c) the identification, measurement, management, monitoring and reporting of risks at group level.

The responsible entity should ensure that such strategic decisions and policies are consistent with the group's structure, size and the specificities of the entities in the group. It also should ensure that the specific operations, which are material, and associated risks of each entity in the group are covered. In addition, it should ensure

that an integrated, consistent and efficient risk management of the group is put in place.

- 2.74 While risk management is the responsibility of the undertaking's AMSB as a whole, the undertaking is expected to designate at least one member of the AMSB to oversee the risk management system on its behalf.
- 2.75 Risk management is a continuous process that is used in the implementation of the undertaking's business strategy and allows for an appropriate understanding of the nature and significance of the risks to which it is exposed, including its sensitivity to those risks and its ability to mitigate them.
- 2.76 Within an undertaking there has to be a coordinated and integrated approach to risk management and a common "risk language" across the organisation.
- 2.77 It is the responsibility of the undertaking to choose the way it defines and describes its risk appetite and overall risk tolerance limits. Nevertheless risk appetite and overall risk tolerance limits have to reflect the following characteristics:
- a) Risk appetite addresses the attitude of the AMSB toward the main categories of risks. It needs to be clear and detailed enough to express and reflect the strategic high level objectives of the AMSB. It may include a quantitative assessment in terms of risk and capital. The AMSB will give appropriate directions concerning the definition of risk appetite.
 - b) "Overall risk tolerance limits" expresses the restrictions the undertaking imposes on itself when taking risks. It takes into account:
 - i. the relevant constraints that effectively limit the capacity to take risks. These constraints can go beyond the framework of solvency as defined in Solvency II;
 - ii. the risk appetite; and
 - iii. other relevant information (e.g. current risk profile of the undertaking, interrelationship between risks).
- 2.78 The definition of overall risk tolerance limits is understood and endorsed by the AMSB.
- 2.79 The risk tolerance limits defined for all relevant risk categories are in line with the overall risk tolerance and limits to guide day-to-day business operations.
- 2.80 The AMSB is also responsible for the approval of any periodic revision of the main strategies and policies of the undertaking in terms of risk management.
- 2.81 The embedding of the risk management system in the organisational structure is demonstrated by adequate risk management processes and procedures across the undertaking and adequate consideration of the risks involved in all major decisions.
- 2.82 The risk management system of entities belonging to groups is necessarily linked to the group's business strategy and operations. The risk management strategy is underpinned by an integrated framework of responsibilities and functions driven from group level down to individual levels. The AMSB of the entities within the group, each within the scope of its duties, are responsible for

implementing the risk management strategies and policies established by the AMSB of the entity responsible for fulfilling the requirements at group level.

- 2.83 The identification and measurement or assessment of risks is to be documented.
- 2.84 Internal risk reporting is required to be a continuous process within all levels of the undertaking. The frequency and content of reporting to the AMSB ensures that it has all necessary current information for its decision-taking with an appropriate level of detail.

Guideline 18 - Risk management policy

The undertaking should establish 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, area of risks and any potential aggregation of risks;
- c) describes the connection with the overall solvency needs assessment as identified in the ORSA, the regulatory capital requirements and the undertaking's overall risk tolerance limits;
- d) specifies risk tolerance limits within all relevant risk categories in line with the undertaking's risk appetite;
- e) describes the frequency and content of regular stress tests and the situations that would warrant ad-hoc stress tests.

- 2.85 The risk management policy covers all material risks, including emerging risks⁴, quantifiable or non-quantifiable and reputational and strategic risks where relevant.
- 2.86 The risk management policy has to consider not only each relevant category and area of risks but also potential accumulation and interactions of risks. Where relevant, the risk management policy will also consider indirect effects of risks (e.g. indirect exposure to liquidity risks with regard to gearing, margin calls on derivatives or stock lending positions).
- 2.87 In addition to specific stress tests prescribed under the supervisory regime, the undertaking is expected to employ stress tests as tools in its risk assessment process. The risk management policy sets out the frequency and content of these stress tests.
- 2.88 The regular risk-specific stress tests are tailored by the undertaking to its risk profile. To this purpose the undertaking has to identify possible short and long term risks and possible events or future changes in economic conditions that could have an unfavourable effect on its overall financial standing and determine their capital impact.
- 2.89 An undertaking may also make use of reverse stress testing, which identifies circumstances and that would threaten the viability of the undertaking, and describe the precautions it is taking.

⁴ Emerging risks are newly developing or changing risks which are difficult to quantify and which may have a major impact on the undertaking.

- 2.90 The undertaking will have to choose adequate scenarios to serve as basis for its risk assessment process. The scenario analyses are based on an analysis of the worst (i.e. most severe but plausible) cases the undertaking could face and take into account any material second order effect that may arise. The risk management policy sets out the frequency and content of these stress tests and scenario analyses.
- 2.91 Although each individual undertaking within a group is responsible for its risk management policy, a general steer is expected to be provided by the responsible entity. In providing its steering, the entity responsible is expected to take into consideration the impact on and the compatibility with the individual undertaking's risk management strategies and policies bearing in mind possible discrepancies between the group perspective and local market specificities.

Guideline 19 - Risk management function: general tasks

The undertaking should require the risk management function to report to the AMSB 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 AMSB.

- 2.92 Article 44(5) of Solvency II requires the risk management function to take on additional tasks that relate to the use of partial or full internal models: namely its design and implementation. By contrast Solvency II does not explicitly assign any specific task with regard to internal models to the actuarial function although the actuarial function is required to contribute to the effective implementation of the risk management system, which includes the internal model. This, however, does not preclude the risk management function from calling upon expertise from other functions in particular the actuarial function. Hence there needs to be in place a communication loop to pass the detailed actuarial perspective to the risk management function and in return receive the insights on the internal model.
- 2.93 The risk management function also needs to liaise closely with users of the outputs of the internal model.
- 2.94 If the undertaking uses an internal model, it should provide for its integration into a comprehensive risk management system so that it is able to monitor that the internal model is and remains appropriate to the undertaking's risk profile.
- 2.95 Appropriate communication channels ensure that the risk management function to be able to call upon expertise from other functions as needed and liaise with the users of the internal model in order to fulfil its tasks under Article 44 (5) of Solvency II.
- 2.96 A close co-operation between the actuarial function and the risk management function as specified in Article 259 (2) (c) of the implementing measures is needed in relation to the tasks required by Article 44(5) of Solvency II in order to provide detailed actuarial information on the internal model to the risk management function. It is the task of the risk management function to assess

the internal model as a tool of risk management and as a tool to calculate the undertaking's SCR.

- 2.97 Documentation of the internal model, and any subsequent changes to it, is maintained by the risk management function so that these are explained in the context of the risk management system.
- 2.98 The information about the performance of the internal model that the risk management function is required to give to the AMSB according to [Article 44(5)(d)] needs to be documented. These reports will be tailored to the needs of the AMSB, enabling its members to understand all the relevant facts and their implications, providing a reliable basis for necessary management decisions, as well as enabling the AMSB to fulfil its role of being responsible for the ongoing appropriateness of the design and operations of the internal model.

Guideline 20 - Underwriting and reserving risk management policy

In its risk management policy, the undertaking should cover at least the following with regard to underwriting and reserving risk:

- a) the types and characteristics of the insurance business, such as 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 process of designing a new insurance product and the premium calculation, the undertaking takes account of the constraints related to investments;
- e) how, in the process of designing a new insurance product and the premium calculation, the undertaking takes account of reinsurance or other risk mitigation techniques.

2.99 Where appropriate, the policy for underwriting and reserving risk may also include:

- a) the maximum acceptable exposure to specific risk concentrations;
- b) internal underwriting limits for the various products or classes; and
- c) considerations regarding reinsurance and other risk mitigation strategies and their effectiveness.

2.100 The undertaking ensures that all policies and procedures established for underwriting are applied by all distribution channels of the undertaking.

2.101 The undertaking needs to take into account the constraints related to investments in the design of new products. For example:

- a) an undertaking planning to sell a new life product with a minimum guaranteed rate has to take into account the return available on the market.

- b) an undertaking planning to sell a new Property and Casualty contract has to take into account the liquidity constraints that could be linked to the contract.

Guideline 21 – Operational risk management policy

In the risk management policy, the undertaking should cover at least the following with regard to operational risk:

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

The undertaking should have processes to identify, analyse and report on operational risk events. For this purpose, it should establish a process for collecting and monitoring operational risk events.

For the purposes of operational risk management, the undertaking should develop and analyse an appropriate set of operational risk scenarios based on at least the following approaches:

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

2.102 As operational risk is typically harder to identify and assess than other types of risks, it is even more important for the undertaking to have a conscious approach to it in its overall risk management. As some of the risk comes from the undertaking itself (e.g. inadequate or failed internal processes, personnel or systems), the undertaking plays a role in the occurrence and unfolding of operational risks. This is also partly true for operational risks having an external event for a cause.

2.103 It is important to note that because operational risks tend to interact with the other risk types they will not be assessed in isolation, but rather be considered alongside the assessment of the other risk types.

2.104 Operational risk may materialize through personnel execution errors, frauds, and processing failures as well as through the direct and indirect consequences of natural or man-made disasters such as terrorist attacks, fire, flood, earthquake and pandemics. These natural or man-made disasters are the high impact-low frequency type of operational risks which need to be considered when looking at scenario analysis. As their impact may be potentially catastrophic, the undertaking pays particular attention to them and develops early warning systems that allow for an effective and timely intervention.

2.105 For the development of scenarios, the undertaking takes into account that the different types of operational risk that are defined in article 13(33) of Solvency II are not strictly separated and that using the two starting points (start from a failure of internal process, system or personnel on one hand or external causes on the other hand) to develop the scenario set will give better chances to have

a more comprehensive list of relevant scenarios. Very severe and unlikely but not impossible scenarios must also be considered.

- 2.106 To perform this analysis the undertaking can use pre-defined categories of operational risks and lists of its key processes. However, each undertaking is free to define a categorisation that better suits its specificities.
- 2.107 The analysis of stress tests and scenarios for the operational risk framework might differ from other types of stress or scenario analysis (e.g. financial), as the definition of the different stages of the scenario (cause, failure of process, impacts) will be a key element of the analysis and monitoring of the risks. The main reason for this is that the controls and corrective measures that the undertaking will put in place will have an effect on the scenario itself.
- 2.108 In the case of operational risk, prevention and corrective actions take precedence over the precise measure. Identifying operational risks is very closely linked to prevention, mitigation and corrective measures.
- 2.109 The continuous monitoring and control of operational risks implies that all personnel are aware of the importance of this type of risk.
- 2.110 The controls and mitigation actions need to be reviewed periodically taking into account the evolution of the operational risk and knowledge of operational risk evolutions.
- 2.111 Examples of mitigation actions are:
- a) insurance (liability insurance, key person insurance, fire insurance, etc.);
 - b) automation of processes; and
 - c) back up of data.
- 2.112 The undertaking is also expected to put in place key risk indicators.
- 2.113 For the purposes of operational risk events analysis, an undertaking may also consider how external data could supplement its collection of internal operational risk events data to produce more reliable estimates of operational risk events.
- 2.114 On each concerned event, at least the following information is needed:
- a) The cause of the event;
 - b) The consequences of the event; and
 - c) The actions taken or not on account of the event.
- 2.115 When defining the perimeter (e.g. materiality threshold) of the events that will be collected, the undertaking would have to keep in mind that:
- a) Operational risk can be both related to high frequency/low severity events or to low frequency/high impact events; and
 - b) Some events that have had no negative impact (e.g. near misses) may be very useful to be analysed to monitor more material operational risks.

Guideline 23 - Reinsurance and other risk-mitigation techniques – risk management policy

In the risk management policy the undertaking should cover 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 tolerance limits and which kind of reinsurance arrangements are most appropriate considering the undertaking's risk profile;
- b) principles for the selection of such risk mitigation 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 procedures to deal with any timing mismatch between claims' payments and reinsurance recoverable.

2.116 The use of reinsurance and similar risk mitigation techniques constitute an ongoing process that may be used to keep the undertaking's risks within the scope of the approved risk tolerance limits. In using these techniques the undertaking has to consider the potential new risks they carry, such as the risk of counterparty default.

2.117 The undertaking develops a written analysis of the functioning and inherent material risks of the risk mitigation used. In particular, subject to the principle of proportionality, it will document the risks that can derive from the risk mitigation, the actions adopted to face such risks and the potential consequences of the risks (i.e. in a worst-case scenario).

2.118 When undertakings use SPVs, the following principles have to be considered:

- a) the fully funded requirement must be actively monitored by the undertaking through its system of governance; and
- b) any remaining risk (credit, market, liquidity, operational risk or 'burn-through' that may occur if the insured cost were to exceed the maximum amount payable by the SPV) from the SPV must be fully taken into account in the undertaking through its risk management system and also taken into account within the calculation of its regulatory capital requirements. The undertaking must be particularly aware of any residual insurance risk arising from the SPV if there were losses in excess of those envisaged at the time of authorisation. These losses above the funding provided would revert back to the undertaking.

Guideline 24 - Strategic and reputational risk

The undertaking should identify, assess and monitor the following situations:

- a) actual or potential exposure to reputational and strategic risks and the correlation between these risks and other material risks;
- b) key issues affecting its reputation, considering the expectations of stakeholders and the sensitivity of the market.

2.119 The following risks, not explicitly mentioned in Article 44 of Solvency II, are considered due to the potential impact their crystallisation could have on the business of the undertaking:

(a) strategic risk; and

(b) reputational risk.

2.120 Strategic risk is a function of the incompatibility between two or more of the following components: the undertaking's strategic goals; the business strategies developed, the resources deployed to achieve these goals, the quality of implementation and the economic situation of the markets the undertaking operates in.

2.121 The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The undertaking's internal characteristics are evaluated against the impact of economic, regulatory, and other environmental factors including: positions vis-à-vis competitors, suppliers and customers and their possible evolutions, opportunities of entry for new competitors, products or technologies.

2.122 The business strategy of the undertaking will incorporate its risk management practices. In this sense, the undertaking will have a process for setting strategic high-level objectives and translating these into detailed shorter-term business and operation plans.

Guideline 25 - Asset-liability management policy

In its risk management policy the undertaking should cover 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;
- d) a description of the underlying methodology and frequency of stress tests and scenario tests to be carried out.

2.123 Asset-liability management (ALM) is the management of a business in such a way that decisions on assets and liabilities are coordinated in order to manage the exposure to the risk associated with the variation of their economic values.

2.124 Along with the investment strategy, an ALM strategy describes how financial and insurance risks will be managed in an asset-liability framework in the short, medium and long term. Where appropriate the investment strategy and the ALM-strategy could be integrated in a combined investment/ALM-strategy.

2.125 When choosing from the different ALM techniques available for measuring risk exposure, an undertaking relies on measurement tools that are consistent with the risk characteristics of the lines of business and its overall risk tolerance limits.

2.126 In order to provide for the effective management of assets and liabilities, the undertaking needs to ensure appropriate and continuing liaison between the

different areas within its business involved in the ALM, such as off-balance sheet exposures or introduction of new products.

2.127 The management of the term structure of the portfolio is mainly done according to the term structure of the liabilities. A range of more or less sophisticated techniques can be used, e.g. duration, convexity, maturity buckets, according to the nature, size and complexity of the portfolio. Size is the factor that most limits the leeway on the management of term structure.

Guideline 26 - Investment risk management policy

In its risk management policy the undertaking should cover at least the following information 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) its quantitative limits on assets and exposures, including off-balance sheet exposures, that are to be established to help to ensure the undertaking achieves 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 adverse scenarios;
- f) the procedure for appropriately valuing and verifying the investment assets;
- g) the procedures to monitor the performance of the investments and review the policy when necessary;
- h) how the assets are to be selected in the best interest of policyholders and beneficiaries.

2.128 The risk management function evaluates whether the internal investment limits are appropriate in view of the undertaking's obligation to meet its liabilities and to comply with the requirements of Article 132(4) of Solvency II. For such purpose an appropriate number of stress tests are carried out on a regular basis.

2.129 The identification, measurement, monitoring, management and control of the investment risks inherent in the respective investment categories are carried out using suitable and acknowledged methods.

2.130 The undertaking has adequate internal control procedures in order to safeguard that the investment activity is properly reviewed and that transactions are always made under consideration of the investment principles and procedures approved by the AMSB; these control procedures must be aligned with the risks arising from investment activities. Such risks may include, but are not limited to, those risks involving coordination between front and back office, compliance with authorisations and trading limits, agreement of parties involved in a transaction, timely documentation of transactions, verification of quoted prices, traceability and tractability.

2.131 The risk management system has to put in place and monitor internal quantitative limits for each type of assets, including off-balance sheet exposures, considered eligible by the undertakings, per counterparty, geographical area or industry with the aim of managing risks in an appropriate manner and protecting the interests of policyholders.

Guideline 27 - Liquidity risk management policy

In its risk management policy the undertaking should cover at least the following information 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) identification and costs of alternative financing tools;
- e) consideration of the effect on the liquidity situation of expected new business.

2.132 The purpose of liquidity risk management is to ensure that obligations to policyholders can be met whenever they fall due. The required degree of liquidity in the investment portfolio can differ amongst undertakings according to the nature of the insurance business, especially the possibility to foresee the amount and the time of the insurance payments.

2.133 An appropriate buffer for liquidity shortfalls is understood as having enough liquid assets and not as holding additional capital.

2.134 Short term liquidity, or cash management, includes the day-to-day cash requirements under normal business conditions. Liquidity considerations over the long term need to be assessed in a way which takes into consideration the possibility of various unexpected and potentially adverse business conditions where asset values may not be realised for current market values, including situations where accelerated sales of assets reduce expected returns. There are also liquidity considerations that arise from policyholder behaviour, such as unexpected or accelerated payments to policyholders as a result of surrenders, large claims, or the exercise of policy options.

2.135 At group level, the management of liquidity risk needs to be adequately supported by clear agreements governing the usage of excess funds, supervision of each entity's financial position and regular stress and transferability testing.

Guideline 28 - Investment risk management

The undertaking should not solely depend on the information provided by third parties, such as financial institutions, asset managers and rating agencies. In particular, the undertaking should develop its own set of key risk indicators in line with its investment risk management policy and business strategy.

When 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.

2.136 The prudent person principle for managing investments has the following characteristics:

- a) Due diligence and process: The prudent person principle is as much a behavioural standard as an assessment of judgments and investment decisions. Prudence is to be found in the process by which investment strategies are developed, adopted, implemented, and monitored in light of the purposes for which funds are managed, as well as in the outcomes.
- b) Care, skill and delegation: The undertaking, while performing investment management has an adequate understanding of the risks associated with its investments, its investment risk management policy, the necessary level of "familiarity" with the liability and regulatory constraints to appropriately carry out its responsibilities. Similarly, the undertaking must have or acquire the care and skill sufficient to the tasks of investment management for which it is responsible. To obtain a sufficient level of skills satisfying the prudent person principle, the undertaking may obtain advice from relevant experts and delegate various activities to those with the requisite skill. When employing an expert:
 - i) the undertaking is responsible for assuring that the expert actually has the skills for which he or she is being employed and, therefore, will adequately investigate the expert's qualifications and experience.
 - ii) the undertaking also ensures that employed experts acquire sufficient familiarity with the specific nature and needs of the managed portfolios by providing them with complete, accurate and sufficient information so that they can appropriately formulate requested advice or carry out delegated tasks.
 - iii) the undertaking assesses whether the hired parties have any conflicts of interest that could provide inappropriate incentives to act contrary to its interests.

2.137 Duty to monitor: Even when delegating tasks, the undertaking remains responsible for monitoring and reviewing the activities delegated to assure that they have been appropriately and prudently carried out. This would include the monitoring and reviewing of investment managers based upon the investment risk section of the risk management policy and review procedure.

- a) Duty to protect policy holders and beneficiaries interest: The undertaking protects the policy holders' and beneficiaries' interests considering that risks such as legal risk, reputation risks,

commercial risks, and operational risks resulting from a lack of care may also impair its solvency. A special emphasis on this point is made on unit-linked business.

- b) Principle of diversification: The investments in portfolios managed by the undertakings are suitably diversified. It requires both diversification among appropriate asset classes and within each asset classification, in order to avoid the unwarranted concentration of investment and the associated accumulation of risk in the portfolios.

2.138 Each portfolio contains investment related risks which can endanger the solvency position. The undertaking needs to be able to identify measure, monitor, manage and control these risks. The composition of the portfolio of assets is at any time the result of a well-structured, disciplined and transparent investment process which consists of the following components:

- a) the investment risk management policy has to be implemented by an investment management with the appropriate skills and resources;
- b) continuous independent control of the investment activity by the employees entrusted with this task by comprehensive and, precise systems for identifying, measuring, monitoring, managing and controlling the investment risks and their aggregation on different levels;
- c) appropriate procedures for the measurement and evaluation of the investment result; and
- d) appropriate reporting procedures.

2.139 The qualitative features of security, quality, liquidity and profitability apply to the portfolio as a whole and not to individual investments. Hence, undertakings may have individual investments that do not fulfil every qualitative feature even if they will finally contribute to the security, quality, liquidity and profitability of the portfolio as a whole.

2.140 In order for these qualitative features to provide a real benchmark against which compliance can be assessed, it needs to be specified to what extent individual investments do not necessarily have to meet all these qualitative features. Assets that do not fulfil every qualitative feature must be kept at prudent levels.

Guideline 29 – Assessment of non-routine investment activities

Before performing any investment or investment activity of a non-routine nature the undertaking should carry 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 policyholders' interest, liability constraints set by the undertaking and efficient portfolio management;

- d) the impact of this investment or investment activity on the quality, security, liquidity, profitability and availability of the whole portfolio.

The undertaking should have procedures that require that where such 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 AMSB of the undertaking.

2.141 A not routinely employed investment or investment activity, such as a large or complex investment, is one that the undertaking does not perform on a regular basis and which is therefore out of the ordinary. The use of derivatives may not be exceptional as such but is considered non-regular as derivatives have to be tailored in each case to serve a specific purpose.

2.142 Investment activity means any action related to investment management (e.g.: sale of call options, security lending, issuance of an instrument).

2.143 The impact on the quality, security, liquidity, profitability and availability of the whole portfolio has to be such that it improves the characteristics of the portfolio and does not deteriorate significantly one characteristic.

2.144 Where the investment or investment activity entails a significant risk or change in the risk profile, this will lead to the requirement to perform a new ORSA.

Guideline 30 – Security of the investment portfolios

The undertaking should regularly assess the security of the investment portfolios by considering at least:

- a) the characteristics that justify, guarantee or affect the value of the assets with regard to events that could potentially change these characteristics;
- b) the diversification of the assets.

2.145 A secure investment portfolio reflects the acceptable level and nature of risks that an undertaking is willing to accept, as well as the steps taken to ensure the undertaking remains within those levels. Considering that the security of a portfolio is a relative notion (with regards to liability constraints for example). It is also a non-permanent and definitive characteristic that has to be regularly reviewed and monitored.

2.146 When assessing and continuously monitoring the security of the portfolio, the undertaking needs to take into account the value of the assets of the portfolio as well as other characteristics of the assets such as:

- a) Tangibility;
- b) Sustainability;
- c) Rarity;
- d) Demand;
- e) Liquidity;

- f) Credit quality of counterparties;
- g) Existence and quality of collateral or asset backing the assets;
- h) Gearing or encumbrances;
- i) Tranches; and
- j) Localisation, availability of the asset.

2.147 These characteristics are also to be considered with regard to stressed situations that may change them. They are to be considered prior to other considerations that could be misleading if considered in isolation, e.g. the past evolution of the quotation of the asset considered, reputation of an asset manager. A comprehensive knowledge of these characteristics is the basis for a good understanding of the assets comprising the portfolio of the undertaking.

2.148 Diversification of the portfolio can, in many cases, be a good method to increase the security of a portfolio. However, diversification is not a purpose in itself and its effects have to be properly assessed.

2.149 Security will also be considered in the selection of the investments and the design of their terms. This will be considered for all the components of any investment management action (e.g.: security lending and repo, gearing).

2.150 Any investment or investment management action will be made according to the general goals and constraints of the portfolio management and stated investment objectives and, at the minimum, will not endanger the security of the portfolio.

2.151 The principle of security covers also the impact of assets that are indirectly held.

2.152 Lending assets can diminish the security of these assets and, thus, of the whole portfolio. This security can be partially restored with collateral, for example. When receiving collateral for security lending and repos, the undertaking will pay attention to its adequacy, their acceptability as part of a risk mitigation technique, and verify that the credit risk on the collateral is not unduly correlated with that of the counterparty to the lending or repo transaction. The undertaking will also set internal limits, concerning at least the number, the amount and the duration of lendings and repos, relating to such investments and justify these investments by reference to its business strategy and its risk and liquidity management.

2.153 Undertakings must have access to information regarding the level of debt for the funds in which they invest. As geared funds are by nature more risky, investment in such structures must be limited.

Guideline 31 - Profitability

The undertaking should determine the returns it seeks from its investments taking into account the need to obtain a sustainable yield on the asset portfolios, security and liquidity requirements, as well as the capital market situation.

When considering the profitability of assets, the undertaking should take into account

any interest rate guarantee, and any disclosed policy on future discretionary benefits and reasonable policyholders' expectations.

2.154 Where the undertaking invests in assets which at the time of the acquisition have a very low guaranteed or no basic interest yield at all, or if the overall yield of which is essentially to be generated from another yield source, such as from a share portfolio for structured products, the undertaking needs to consider the risk it is capable of sustaining when determining the extent to which it is prepared to invest in such assets.

Guideline 32 - Availability

When assessing the availability of assets the undertaking should not limit this to localisation. The undertaking should determine how frequently this assessment should be performed.

2.155 Availability could be impaired for example by:

- a) non-transferability;
- b) legal issues in other countries;
- c) currency measures;
- d) custodian risk;
- e) over-collateralisation and
- f) lending.

2.156 At group level the participating undertaking should assess in particular the availability of assets in non-EEA countries.

Guideline 33 - Conflicts of interests

The undertaking should describe in its investment policy how it identifies and manages any conflicts of interest that arise regarding investments, irrespective of whether they arise in the undertaking or in the entity which manages the asset portfolio. It should also document the actions taken to manage such conflicts.

2.157 Conflicts of interest may arise when undertakings have an incentive to invest in assets, which do not correspond to the objectives of the contracts held in their portfolio and/or the best interests of all their policyholders or beneficiaries; this may take various forms, for instance:

- a) In case of guaranteed rates for only certain types of contracts, incentive to invest in assets with higher return but also higher risk that might lead, in case of losses on those assets, to lower returns for contracts without a guaranteed rate; and
- b) Incentive or obligation of the parent undertaking to invest in a way that would interfere with the undertaking's compliance with the requirements in Article 132 of Solvency II. For example, the

undertaking may be pressured to invest in bonds of the parent undertaking, which may carry higher risks, for example lower diversification or liquidity, than assets with a similar return, or which increase the risk of contagion if the asset became impaired. In that scenario the parent would possibly be unable to recapitalise the insurer, and hence this may be contrary to the interests of policyholders and beneficiaries.

Guideline 34 - Unit-linked and index-linked contracts

The undertaking should ensure that its investments of unit-linked and index-linked contracts are selected in the best interest of policyholders and beneficiaries taking into account any disclosed policy objectives.

In the case of unit-linked business the undertaking should take into account and manage the constraints related to unit-linked contracts, in particular liquidity constraints.

2.158 In relation to unit-linked contracts, the undertaking is expected to consider the liquidity risk with reference to its liabilities arising from the obligations and representations to policyholders and beneficiaries. In particular this includes the assessment of the ability for policyholders and beneficiaries to redeem their unit-linked investments, taking into account the immediacy with which they must discharge their obligations (i.e. the notice period).

2.159 The operation of unit-linked and index-linked contracts requires for ALM reasons that the underlying assets of the contracts are sufficiently liquid that the purchase and sales of those assets can be realised consistently with the premium payment and redemptions on the contracts.

2.160 If it is not possible to sell particular assets in time or at a fair price to meet surrender payments, the undertaking needs to consider the interests of the remaining unit holders and whether there is a need to sell other liquid assets. A consequential risk is that the residual investment portfolio of the fund becomes unbalanced, in a way that it no longer conforms to the investment mandate and/or the risk profile disclosed to policyholders. The undertaking therefore needs to take into account the broader impact on the linked fund or portfolio.

2.161 The undertaking needs to ensure that no additional risk results from the unit-linked contracts in a way that could hurt other policyholders and beneficiaries, e.g. when the undertaking uses derivatives to limit the maximum possible loss.

Guideline 35 - Assets not admitted for trading on a regulated financial market

The undertaking should implement, manage, monitor and control 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.

The undertaking should treat 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.

- 2.162 Where mark-to-model valuation is applied, the risk management function is responsible for model sign-off and review, model sign-off and review, independent price verification and stress-testing, as well as internal control processes needs to take place. On a regular basis, the undertaking is expected to assess the need to develop back-up valuation models for complex or potentially illiquid instruments. These methods and models have to be benchmarked, extrapolated or otherwise calculated as far as possible from market inputs. The undertaking is expected to maximise the use of relevant observable inputs and minimise the use of unobservable inputs.
- 2.163 The undertaking is expected to have access to appropriate expertise in order to understand, manage and monitor structured products and their embedded risks. Also, the undertaking needs procedures to evaluate the specific risks associated with these products, especially new concentration risks that may not be obvious.

Guideline 36 - Derivatives

When using derivatives, the undertaking should implement the procedures in line with its investment risk management policy to monitor the performance of these derivatives.

The undertaking should demonstrate how the quality, security, liquidity or profitability of the portfolio is improved without significant impairment of any of these features where derivatives are used to facilitate efficient portfolio management.

The undertaking should document the rationale and demonstrate 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.

- 2.164 With respect to assets other than those covered by Article 132 paragraph 4 of Solvency II Directive, derivatives are only allowed for the purposes of efficient portfolio management or the reduction of risks.
- 2.165 When the undertaking uses derivative products or any other financial instrument with similar characteristics or effects, it needs to put in place procedures to evaluate the strategy to use these types of products and the principles of risk management to be applied to them.
- 2.166 Where the undertaking uses derivatives that can generate losses significantly above the amount initially committed, such as the sale of a call, it is expected to assess the resulting structure of the whole portfolio whether it does create a situation where the possible loss could be unlimited or excessive with regard to the portfolio constraints.
- 2.167 The use of derivative as a hedging tool is expected to be done in a way that does not create any additional risks that have not been assessed previously.
- 2.168 Examples where derivatives are used for hedging and would create new risks:
- a) If the undertaking invests in a mutual fund in which the foreign currency risk is hedged (in the mutual fund) by a derivative with a margin call and the covered assets are not liquid, it can create a liquidity risk in the mutual fund even though economically the risk is hedged;

- b) If the undertaking wants to hedge a security with a negative value using a collar, it can create risks in the income statement even though economically the risk of an asset impairing is hedged; and
- c) If the undertaking wants to hedge against a rise in interest rates, it may buy caps from investment banks, which can create an increased counterparty risk even though economically the risk is hedged.

2.169 With respect to assets covered by Article 132 paragraph 3 of Solvency II directive, derivatives may also be used as an investment strategy.

2.170 When derivatives, used as part of the assets or liabilities held in respect of benefits for which policyholders bear the investment risks, are used as an investment strategy rather than to contribute to a reduction of investment risk or to facilitate efficient portfolio management, then the undertaking reflects the higher risks posed by such transactions within its systems and controls.

Guideline 37 - Securitised instruments

Where the undertaking invests in securitised instruments, it should ensure that its interests and the interests of the originator or sponsor concerning the securitised assets are well understood and aligned.

2.171 The undertaking ensures that the originator does not conclude deals solely because it expects to have essentially a brokerage activity on these deals.

2.172 The undertaking has a clear vision of the purpose followed by the originator, in particular the undertaking ensures that, at least, the assets are not securitised because the conditions on the market have become more risky for these assets.

2.173 Below are possible actions the undertaking could take to ensure that the alignment is in place, it could:

- a) perform due diligence including a risk analysis of the proposed securitised investments;
- b) ensure that the originator has explicitly provided the undertaking with the documentation governing the investment that the originator will retain, on an ongoing basis a net economic interest which, in any event, should not be less than a relevant and pre-determined share;
- c) ensure that the originator meets the following criteria: the originator or, where appropriate, the sponsor finances the transaction, based on sound and well-defined criteria, and clearly establishes the process for approving, amending, renewing and refinancing assets securitised to exposures to be securitised if they apply to exposures which are not currently securitised;
- d) check that the originator or, where appropriate, the sponsor has in place effective systems to manage the on-going administration and monitoring of its assets, risk-bearing portfolios and exposures;
- e) check that the originator or, where appropriate, the sponsor adequately diversifies each asset portfolio based on its target market and overall credit strategy;

- f) ensure that the originator or, where appropriate, the sponsor makes readily available access to all relevant data necessary for the undertaking to comply with any legal requirements set;
- g) check that the originator or, where appropriate, the sponsor has a written policy on asset risk that includes its risk appetite and provisioning policy and how it measures, monitors and controls that risk;
- h) ensure that the originator or, where appropriate, the sponsor discloses the level of its retained net economic interest as well as any matters that could undermine the maintenance of the minimum required net economic interest.

Guideline 41 – Internal control environment

The undertaking should promote 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.

The responsible entity should ensure a consistent implementation of the internal control systems across the group.

2.174 Internal control combines the following aspects:

- a) internal control environment
- b) internal control activities
- c) communication
- d) monitoring

2.175 A high level of integrity is an essential part of the control environment. In reinforcing integrity, the undertaking needs to avoid policies and practices that may provide incentives for inappropriate activities. The undertaking needs to ensure staff are not only fully aware of the internal control system but that they understand their role within it. This ensures the system is fully embedded within the undertaking's culture.

2.176 The undertaking ensures that its written policies on internal control are approved by the AMSB and that they include the means by which the senior management implements the internal control system and keeps it suitable and effective.

2.177 The responsible entity ensures a consistent implementation of the internal control activities across the group. At group level, the responsible entity ensures that within the group's internal control system risk concentration and intra-group transactions are adequately assessed, monitored and reported and taken into account for inter-linkages and interdependencies between the group undertakings.

2.178 An appropriate internal control system includes internal controls at different levels of the organisational and operational structures, for different time periods

and with different levels of detail, as needed. The internal controls are not to be regarded as a standard regular exercise.

2.179 Control activities could, depending on the particular circumstances of the undertaking, include approvals, authorisations, verifications, reconciliations, management reviews, and other appropriate measures applicable to each business area and unit, physical controls, compliance checks with agreed exposure limits and operating principles or instructions and follow-up procedures on non-compliance.

2.180 Internal controls could inter alia comprise:

- a) the applicable data protection requirements;
- b) appropriate security controls; and
- c) access to hardware, systems and data, maintaining the integrity of records and information and thereby protecting the interests of policyholders.

2.181 Internal controls include the task of identifying and managing any areas of potential conflicts of interest appropriately.

Guideline 42 – Monitoring and reporting

The undertaking should establish monitoring and reporting mechanisms within the internal control system which provide the AMSB with the relevant information for the decision-making processes.

2.182 The reporting of the achievement of the main goals and material risks inherent in the business is predefined.

2.183 Quality reports, timely reporting, accuracy, completeness and suggestions for improvements are encouraged.

2.184 Internal communication lines need to encourage the reporting of negative news, particularly when communicated to superiors, to avoid employees suppressing negative information and permit short cut across reporting lines in case the situation calls for such action.

2.185 Monitoring mechanisms include procedures to detect deficiencies.

2.186 Regular monitoring occurs in the course of normal operations and includes on-going management activities and actions taken by all personnel when performing their duties.

Guideline 43 – Independence

When performing an audit and when evaluating and reporting the audit results, the undertaking should ensure that the internal audit function is not subject to influence from the AMSB that can impair its operational independence and impartiality.

2.187 Internal audit is an independent function established within the undertaking to examine and evaluate the functioning, effectiveness and efficiency of the internal control system and all other elements of the system of governance.

Internal audit assists members of the AMSB in their duty to have an adequate and effective internal control system in place. Internal audit provides the AMSB with analysis, appraisals, recommendations and information concerning the activities reviewed.

- 2.188 Certain undertakings have established separate functions in charge of controlling or monitoring a specific activity or entity of the undertaking. Such functions are part of the internal control system and therefore do not release the internal audit from examining those specific activities or entities. However, for the sake of efficiency, the internal audit may, in carrying out its tasks, use the information reported by the various functions. The operational independence of the internal audit function implies that it is given an appropriate standing within the organization and carries out its assignments without undue interferences and with impartiality.
- 2.189 The AMSB can request that specific areas are included in the internal audit without impairing the operational independence of the internal audit function.

Guideline 44 – Conflicts of interest within the internal audit function

In order to mitigate the risk of any conflicts of interest, the undertaking should rotate staff assignments within the internal audit function regularly.

The undertaking should ensure that internally recruited auditors do not audit activities or functions they previously performed during the timeframe covered by the audit.

2.190 With these measures it is intended that the internal audit function is in a position to perform its assignments with complete objectivity.

2.191 This presupposes that the internal audit is not involved in the operational organization of the undertaking or in developing, introducing or implementing organizational or internal control measures.

2.192 However, the need for impartiality does not exclude the possibility to request from the internal audit function an opinion, on specific matters related to the internal control principles to be complied with.

2.193 Indeed, such consultative function constitutes a secondary task which cannot impede the basic tasks or the responsibility and appraisal independence of the internal audit function.

2.194 In deciding on the frequency of the rotation in its internal audit policy the undertaking has to balance the need for developing expertise with that for maintaining adequate operational independence.

2.195 The internal audit function has to be able to exercise its assignment on its own initiative within the undertaking. It needs to be free to express its findings and appraisals and to disclose them.

Guideline 45 - Internal audit policy

The undertaking should have 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. where appropriate, internal rules setting out the procedures the person responsible for the internal audit function needs to follow before informing the supervisory authority;
- c. where appropriate, the criteria for the rotation of staff assignments.

The responsible entity should ensure that the internal audit policy at the level of the group describes how the internal audit function:

- a. coordinates the internal audit activity across the group;
- b. ensures compliance with the internal audit requirements at the group level.

2.196 The policy is drawn up by the internal audit function and approved by the AMSB.

Guideline 46 – Internal audit plan

The undertaking should ensure that the internal audit plan:

- a. is based on a methodical risk analysis, taking into account all the activities and the complete system of governance, as well as expected developments of activities and innovations;
- b. covers all significant activities that are to be reviewed within a reasonable period of time.

2.197 Each assignment is adequately prepared. Its objectives as well as an outline of the work that is considered necessary to attain is described in an audit program.

2.198 The audit programme is a relatively flexible tool that needs to be adapted and completed according to the findings. It covers the activities that are to be reviews within a reasonable period of time, meaning according to the audit cycle principle.

Guideline 47 - Internal audit documentation

The undertaking should keep a record of the work of the internal audit function, including the work documented in working papers.

In order to allow for an assessment of the effectiveness of the work of the internal audit function, undertakings should document the audits in a way that allows for retracing the audits undertaken and the findings they produced.

2.199 All audit procedures that are part of the assignment have to be documented in working papers. These need to reflect the examinations that have been made and emphasise, and wherever necessary support, the evaluations in the report.

2.200 The working papers must be drawn up according to a well determined method. Such a method must, in particular, allow for the verification whether the assignment was duly performed and to check the manner in which it was performed.

2.201 The internal audit function maintains a record of the assignments performed and of the reports issued together with the working papers.

Guideline 48 – Internal audit function tasks

The undertaking should require that the internal audit function, in the report to the AMSB, includes the envisaged period of time to remedy the shortcomings, and information on the achievement of previous audit recommendations.

- 2.202 A written report of each assignment is issued as quickly as possible.
- 2.203 The written report has to be transmitted to the auditee and the auditee's hierarchy and possibly as an executive summary to the AMSB.
- 2.204 The internal audit function indicates the relative importance of the deficiencies found or recommendations made.
- 2.205 The report covers at least any deficiencies with regard to the efficiency and suitability of the internal control system, as well as major shortcomings with regard to the compliance with internal policies, procedures and processes. It includes recommendations on how to remedy inadequacies and also specifically addresses how past points of criticism and past recommendations have been followed up.
- 2.206 The internal audit function develops appropriate procedures to verify the manner how the recommendations are implemented.
- 2.207 As part of its supervisory task, the AMSB body is expected to regularly discuss the organisation, audit plan, audit programme, adequacy of resources to ensure the proper performance of the activities of the internal audit function and summary of recommendations and their implementation.
- 2.208 The internal audit Function indicates in the report also the persons responsible to remedy inadequacies identified, in order to take evidence of the concrete follow-up of the Audit recommendations. These recommendations are based on the discussion with the auditee. The final decision, as to who is responsible for handling the recommendations the AMSB decides to implement, rests with the AMSB or the audit committee.

Guideline 49 - Tasks of the actuarial function

The undertaking should take 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.

The responsible entity should require that the actuarial function gives an opinion on the reinsurance policy and the reinsurance program for the group as a whole.

- 2.209 One of the tasks of the actuarial function is the coordination of the calculation of technical provisions. This task, as defined in Solvency II, does not explicitly include the actual calculations of the technical provisions. Who should perform the calculation of the technical provisions is left to each undertaking to decide, provided that there is a clear allocation and appropriate segregation of responsibilities to ensure independent scrutiny and validation of the calculation. In cases where both calculation and validation of technical provisions is done by the actuarial function, the undertaking should have in place processes and procedures in order to avoid conflicts of interest and ensure appropriate

independence. The degree of segregation of duties needs to be proportionate to the nature, scale and complexity of the risks inherent in the calculation of the technical provisions.

- 2.210 The undertaking needs to ensure and demonstrate that the processes of calculation and of validation of the technical provisions are independently performed.
- 2.211 The group actuarial function provides advice and an actuarial opinion on: underwriting risks of the group, asset-liability aspects, the group's solvency position, the groups prospective solvency position, such as stress tests and scenario tests in the area of technical provisions and ALM, distribution of dividends in relation to discretionary benefits, underwriting policies, reinsurance arrangements and other forms of risk transfer or risk mitigation techniques for insurance risks. Also advice is given on the adequacy, fairness of premiums and discretionary benefits, or the methodology to determine the same, by the group actuarial function.

Guideline 50 - Coordination of the calculation of technical provisions

The undertaking should require the actuarial function to identify any inconsistency with the requirements set out in Articles 76 to Article 85 of Solvency II for the calculation of technical provisions and propose corrections as appropriate.

The undertaking should require the actuarial function to explain any material effect of changes in data, methodologies or assumptions between valuation dates on the amount of technical provisions.

- 2.212 Both the task of ensuring the appropriateness of the methodologies and of the underlying models used, including the assumptions made in the calculation of technical provisions, and the assessment of the sufficiency and quality of the data used in the calculation of technical provisions are requirements of the coordination of the calculation.
- 2.213 In order to carry out this task, the actuarial function uses methodologies that allow for a complete analysis regarding those requirements.
- 2.214 The methodologies used to calculate the technical provisions should be validated, by validation tools such as back-testing against past experience, giving due considerations to changes over time.
- 2.215 The work required to ensure that an assumption is appropriate has to be proportionate to the impact of a variation in the assumption on the best estimate and to the materiality of the impact for the undertaking.

Guideline 51 – Data quality

The undertaking should require the actuarial function to assess 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. Where relevant, the actuarial function provides recommendations on internal procedures to improve data quality so as to ensure that the undertaking is in a position to comply with Solvency II requirements.

- 2.216 When assessing the appropriateness of the undertaking's segmentation of its insurance obligations into homogeneous risk groups, the actuarial function needs to take any data limitations into account. Limitations may include insufficient granularity and quantity of data.
- 2.217 The appropriate level of granularity is the level that allows the identification of trends affecting the different drivers of risk and ensures that there is sufficient data to enable the implementation of the methodologies and any statistical analysis.
- 2.218 The actuarial function has the task of consulting any relevant market data to perform the modelling of these liabilities and ensuring that these data are appropriately integrated into the model.
- 2.219 The actuarial function performs a process of comparison and validation of technical provisions based on experience and identifies solutions on how to deal with any material differences detected, which may imply revisions of assumptions and methodologies.

Guideline 52 – Testing against experience

The undertaking should ensure that the actuarial function reports any material deviations from actual experience to the projected best estimate to the AMSB. The report should identify the causes of the deviations and, where applicable, propose changes in the assumptions and modifications to the valuation model in order to improve the best estimate calculation.

2.220 Proposals to change assumptions and to modify valuation models in order to improve best estimates have to be evidence-based.

2.221 If a case-by-case approach is used in accordance with Article 82 of Solvency II in the calculation of the best estimate, the actuarial function has to describe the rationale for the assumptions used and to explain how the best estimate has been calculated in a manner compliant with Articles 76 to 86 of Solvency II.

Guideline 53 – Underwriting policy and reinsurance arrangements

The undertaking should require the actuarial function, when providing its opinion on the underwriting policy and the reinsurance arrangements, to take into consideration the interrelations between these and the technical provisions.

2.222 Underwriting policy, reinsurance arrangements and technical provisions are interdependent actions according to the nature of an undertaking's business. Changes in underwriting policy and practice, for example, may not only affect the calculation of technical provisions, but also the adequacy of reinsurance arrangements. Consequently, the actuarial function is expected to identify any important interrelationships between underwriting policy, reinsurance and technical provisions when carrying out its responsibilities as described in Article 48 of the Solvency II Directive.

2.223 The skills and experience of the actuarial function can provide a different perspective from the underwriters' or reinsurance teams' perspectives. This perspective, when communicated to the AMSB, will help to ensure that it is fully

informed. The opinions on the underwriting policy and reinsurance arrangements include, when necessary, recommendations regarding appropriate strategies to be followed by the undertaking in this matter.

2.224 The opinion on the overall underwriting policy may include amongst others the following issues:

- a) whether the product pricing is consistent with the underwriting policy for acceptance of risks;
- b) an opinion on the principal risk factors influencing the profitability of business to be written during the next year, including the potential impact on future profitability of external factors such as inflation, legal risk, changes in business volumes and changes in the market environment;
- c) an opinion on the likely financial impact of any material planned changes in terms and conditions of contracts;
- d) the degree of variability surrounding the estimate of expected profitability; and
- e) the consistency of this degree of variability with the risk appetite of the undertaking.

2.225 Commenting on the overall underwriting policy does not require expressing views on every single policy, but rather on the undertaking's underwriting in general. The scope of the view expressed is determined by what is relevant information for the AMSB in reviewing the undertaking's underwriting policies.

2.226 The opinion on the adequacy of the undertaking's reinsurance arrangements may include amongst others the following issues:

- a) the consistency of the undertaking's reinsurance arrangements with its risk appetite;
- b) the effect of reinsurance on the estimation of technical provisions net of reinsurance recoverables; and
- c) an indication of the effectiveness of the undertaking's reinsurance arrangements in mitigating the volatility of its own funds.

2.227 The opinion on the adequacy of reinsurance arrangements needs to include an assessment of how the reinsurance coverage could respond under a number of stressed scenarios. These scenarios may include situations such as the following: exposure of the undertaking's portfolio of business to catastrophic claims experience, aggregations of risks, reinsurance defaults and potential reinsurance exhaustion.

2.228 The actuarial function provides information to the AMSB to enable it to take decisions concerning the underwriting policy and reinsurance arrangements. The opinions of the actuarial function on the overall underwriting policy and reinsurance arrangements need to include descriptions and examinations of other possible options.

Guideline 54 – The actuarial function of an undertaking using an internal model

The undertaking should require the actuarial function to contribute to specifying which risks within their domain of expertise are covered by the internal model. The actuarial function should also contribute to how dependencies between these risks and dependencies between these risks and other risks are derived. This contribution is based on a technical analysis and should reflect the experience and expertise of the function.

- 2.229 Article 44 (5) of Solvency II sets out that the risk management function is responsible for a number of areas of the internal model. Despite the fact that the risk management function is responsible for the design, implementation, testing and validation of the internal model, it is expected that the actuarial function assists in these tasks. The assistance of the actuarial function in the internal modelling is desirable also because of the close connection and consistency between the valuation of the assets, liabilities and the calculation of the loss Probability Distribution Forecast (PDF). During the calculation of the SCR, amongst others, the uncertainties of the technical provisions are measured, via life underwriting risk module, non-life underwriting risk module.
- 2.230 The design of the internal model is a task that is performed with the contribution provided by the actuarial function, for instance, regarding the scope of the internal model and the complexity of the model.
- 2.231 The level of data quality that is required to perform the modelling of the different risks is a particular factor that needs to be taken into consideration. The actuarial function, as responsible for the analysis of the sufficiency and the quality of the internal and external data to be used in the calculation of technical provisions, is in a position to express an opinion on whether it is appropriate to explore a specific area of modelling in the framework of the internal model, regarding the limitations of data that may apply.
- 2.232 The actuarial function, following its task of coordination of the calculation of technical provisions, assists the risk management function in defining the level of technical complexity that should be associated with the model. The level of complexity will depend, for instance, on the level of completeness of the data, the nature and complexity of the risks and its importance among the other risks.
- 2.233 The assistance of the actuarial function to risk management is particularly important in the modelling of underwriting risks and it is necessary to ensure consistency between the assumptions set to calculate technical provisions and the assumptions inherent to the calculation of the solvency capital requirement.
- 2.234 The actuarial function also has a role in the implementation of the internal model and may also be a user of it. The outputs of the internal model are used by the actuarial function to support the analyses carried out by the function.
- 2.235 In the process of the internal model's implementation, the mutual communication between the actuarial function and the risk management function is needed that both functions insights in the internal model gained by

the two functions are shared between them. This feedback could lead to the detection of shortcomings and to proposals on how to improve the model.

- 2.236 Parts of the validation tasks may include collecting and analysing information, for example providing an analysis of the actual experience against expected experience. It may be that there are systems in place within the sphere of responsibility of the actuarial function which have already been set up to collect this information.
- 2.237 In this case it may be sensible for the actuarial function to be involved in performing some of the tasks in the validation process so the undertaking can streamline processes and facilitate an efficient allocation of tasks.

Guideline 55 - Actuarial reporting to the AMSB

The undertaking should require the actuarial function to report in writing at least annually to the AMSB. The reporting should document all material tasks that have been undertaken by the actuarial functions, their results, clearly identifying any deficiencies and giving recommendations as to how such deficiencies could be remedied.

- 2.238 There may be deficiencies in the specific tasks carried out by the actuarial function, as set out in Article 48 of Solvency II. Such deficiencies identified may relate to data, technical procedures, methodologies or to knowledge or expertise.
- 2.239 Reporting to the AMSB does not require that all material tasks and their results are addressed in one written report. The actuarial function can cover the topics it needs to address in different written reports and submit them to the AMSB at different times as long as each relevant topic is dealt with at least annually.
- 2.240 If there is any material uncertainty about the accuracy of the data, the actuarial function report needs to:
- a) describe the uncertainty; and
 - b) explain any approach taken in light of the uncertainty in the calculation of technical provisions.
- 2.241 In some specific areas, which usually require a higher complexity of the modelling, shortcomings of knowledge or expertise of the personnel may be experienced. This may also be a consequence of the development of new complex products, some for instance with embedded options and guarantees, where difficulties may arise with regard to understanding and predicting the behaviour of assets and liabilities affected by a wide set of risk drivers as well as their interdependencies.

Guideline 56 - Valuation of assets and liabilities other than technical provisions

The undertaking should include in the policies for valuation of assets and liabilities procedures, at least:

- a. the assessment of active and non-active markets;

- b. the model designs and their implementation;
- c. the adequacy of inputs, for example data, parameters and assumptions;
- d. the steps followed during the process of the valuation;
- e. the models' performance;
- f. an independent review and verification;
- g. the regular reporting to the AMSB.

2.242 An undertaking consistently needs to apply an appropriate methodology and criteria to determine whether markets are active based on the criteria defined within international accounting standards, as endorsed by the Commission in accordance with Regulation (EC) No 1606/2002. Methodologies, and the resulting assessments, need to be adequately documented.

2.243 The system of governance addresses the characteristics and complexity of the valuation process. The undertaking needs to give special consideration to financial assets and liabilities that are difficult to value or for which the undertaking's valuation is inherently uncertain. In general, more extensive governance procedures would be required when using an alternative valuation method rather than quoted market prices.

2.244 The valuation policies and procedures, when alternative methods are used, need to address the risk of:

- a) inadequate inputs, e.g. questionable data quality, flawed assumptions;
- b) invalid internal logic of the valuation method, e.g. lack of sound methodology or mathematical techniques, inconsistency with market practice, programming errors; and
- c) inappropriate application of results, e.g. through misunderstanding of the model's limitations.

2.245 A first pre-requisite is a thorough understanding of the valuation methods that are used. This applies to all levels of the organisation that have a role in the valuation of assets and liabilities.

2.246 The evaluation whether the assumptions are reasonable and appropriate has to take into consideration the prevailing good practice with regard to the selection of assumptions for similar purposes.

2.247 The undertaking needs to consider carefully if its IT-system matches the complexity of its valuation method and the required internal controls.

Guideline 57 – Data quality control procedures

The undertaking should implement data quality control procedures to identify deficiencies and to measure, monitor, manage and document their data quality. These procedures should include:

- a. completeness of data;
- b. appropriateness of data, both from internal and external sources;
- c. independent review and verification of data quality.

The policies and procedures implemented by the undertaking should address the need

to periodically review market data and inputs against alternative sources and experience.

2.248 The data used as an input for the valuation process has to be fit for purpose. It may be necessary to adjust market data to better represent the characteristics of the asset or the liability. In this case, proper procedures and justification are needed.

2.249 Data completeness and appropriateness need to be assessed through a series of checks. Any relevant analysis performed by internal audit, external audit or other parties needs to be taken into account.

2.250 If this identifies data deficiencies, the undertaking needs to document them, identify the possible impact, and assess if and how the data quality can be improved.

2.251 When using alternative valuation methods, undertakings need to make sure that inputs capture the characteristics and risks of the asset or liability.

2.252 Reliability of inputs is achieved by a combination of internal controls, including procedures which ensure that:

- a) inputs are only made by authorised users;
- b) inputs have not been compromised by subsequent changes; and
- c) all changes to the inputs are monitored.

2.253 This relates to valuation data as well as to the parameters and assumptions used in the valuation method.

Guideline 58 – Documentation of the review process

The undertaking should provide adequate documentation in which the different inputs and steps in the valuation process are recorded.

2.254 A key element in ensuring data integrity is the ability to generate an audit trail, which documents sequentially the relevant steps have been taken. An audit trail is a valuable tool to identify strengths and weaknesses in systems, processes or procedures.

2.255 An audit trail requires that the undertaking establishes a reliable and transparent chronological record of the elements and steps in the process that impact the valuations: the “who”, “what”, “when” and “where” of the different inputs and steps in the process are recorded.

2.256 The internal controls and the way in which the steps are recorded to support the audit trail, have to be proportionate to the complexity of the validation process and the possible impact in the decision making process.

Guideline 59 – Documentation when using alternative valuation methods

Where alternative methods for valuation are used, the undertaking should document:

- a. a description of the method, purpose, key assumptions, limitations and output;

- b. the circumstances under which the method would not work effectively;
- c. description and analysis of the valuation process, and the controls linked with the method;
- d. an analysis of valuation uncertainty linked with the method;
- e. a description of back-testing procedures performed on the results and, where possible, a comparison against comparable models or other benchmarks, which should be carried out when the valuation method is first introduced and regularly thereafter;
- f. a description of the tools or programs used.

2.257 The documentation for each valuation method needs to include an operating manual or similar document that describe the procedures used to operate, maintain and update the valuation method. This manual needs to be sufficiently detailed to enable a qualified third-party to operate and maintain the valuation method independently.

Guideline 60 - Independent review and verification of valuation methods

The undertaking should ensure that an independent review of the valuation method, following [Article 257bis (4)(b)] takes place before the implementation of a new method or a major change, and on a regular basis thereafter.

The undertaking should determine the frequency of the review in line with the significance of the method for the decision-making and risk management processes.

The undertaking should apply the same principles for the independent review and verification of both internally developed valuation methods or models and for vendor provided valuation methods or models.

The undertaking should have processes in place to report the results of the independent review and verification, as well as the recommendations for remedial actions to the appropriate management level of the undertaking.

2.258 The independent review and verification process can be undertaken internally or externally.

2.259 The responsibility for design and implementation of the valuation approaches has to be separated from the responsibilities to perform the independent review and verification.

2.260 When using external valuation methods or models, the undertaking has to understand the methodologies used, the assumptions underlying the model, the outputs generated and the sensitivities implied by the model.

2.261 The independent review and verification of vendor models includes a review of any vendor information that describes the theory and logic supporting the model and an assessment of whether the theory and logic are generally accepted and supportable.

2.262 The task of the independent review and verification usually lies within the risk management function.

2.263 The independent review and verification reports are expected to provide information on:

- a) the quality of the valuation methods;

- b) any known design weaknesses in valuation methods used;
- c) any concerns relating to the accuracy and appropriateness of the inputs, such as data, parameters and assumptions used; and
- d) comparisons with previous reports.

Guideline 61 - Oversight by the AMSB

The undertaking should ensure that the AMSB and other persons who effectively run the undertaking are able to demonstrate an overall understanding of the valuation approaches and the uncertainties involved in the valuation process to allow a proper oversight of the risk management process concerning valuation.

2.264 Supported by the appropriate key functions, a proper oversight will include:

- a) periodical monitoring of the effectiveness of the approved policies and procedures, including those on the independent review and verification;
- b) a review of reports on independent review and verification, documentation and internal control; and
- c) intervening, as appropriate, to ensure proper valuation risk management.

Guideline 62 – Request to the undertaking by the supervisory authority, for an external independent valuation or verification

The supervisory authority should consider requesting an independent valuation or verification from the undertaking at least when there is a risk of misstatements in the valuation of material assets or liabilities, with possible material consequences for the undertaking's solvency situation.

2.265 The [draft Delegated Acts] give supervisory authorities the opportunity to require an external independent valuation or verification of the value of material assets and liabilities. The above guideline is not intended to restrict this ability, but rather to highlight a specific case where such an independent valuation or verification promotes convergence of supervisory practices.

2.266 The risk of a material misstatement is increased, inter alia, when:

- a) there is an inactive market for the asset or liability;
- b) the auditor of the undertaking has raised concerns regarding aspects of the preparation of the undertaking's general purposes financial statements; and
- c) the valuation of the asset or liability has not moved in line with the expectations of the supervisor, e.g. the valuation has remained constant over a considerable period of time, the valuation has not moved in line with similar type assets or liabilities in the market etc.

2.267 Even where an undertaking's valuation of an asset or liability has some or all of the characteristics outlined, this does not necessarily mean that the valuation used by the undertaking is incorrect.

2.268 When considering requesting an independent valuation or verification, supervisors have to take into account an opinion that has been provided by an external auditor. When items are recognised in the general purposes financial statements at their economic value, i.e. no adjustment needed for the Solvency II balance sheet, or when the Solvency II balance sheet is externally audited, the audit of those statements may imply sufficient verification. However, the supervisor may deem a separate independent valuation or verification still necessary in some circumstances.

2.269 The external independent valuation or verification consists of the performance of a valuation by an external independent party. The external independent verification consists of the review by an external independent party of the valuation performed internally by the undertaking.

2.270 The responsibility for a proper valuation remains with the undertaking's management. The expert enables the supervisor to make further judgments about the undertakings' valuation if necessary.

2.271 Verification requires that the expert assesses the adequacy and the relevance of the methods, assumptions and inputs used by the undertaking for the valuation of the items under review. The verification also requires the expert to give an opinion on the result of the valuation.

2.272 The undertaking needs to make the documentation needed to perform his duties available to the expert, including:

- a) policies and procedures established on significant valuation methodologies;
- b) assumptions and data entered into the methods; and
- c) the results of the undertaking's independent review and verification activities.

Guideline 63 – Independence of the external expert

The undertaking should be able to demonstrate to the supervisory authority that the external valuation or verification has been performed by independent experts with the relevant professional competence, due care and relevant experience.

2.273 As the external valuation or verification is performed by external experts, the concept of independence has some specific characteristics, which differ from the concept of independence in other parts of this guidance.

2.274 Independence requirements mean that there are no potential conflicts of interests between the expert and the undertaking. Therefore, independence comprises of:

- a) 'Independence of Mind' - The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an expert to

act with integrity and exercise objectivity and professional scepticism; and

- b) 'Independence in Appearance' - The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that an expert's, integrity, objectivity or professional scepticism have been compromised.

2.275 The principle of integrity imposes an obligation to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

2.276 The principle of objectivity imposes an obligation on experts not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. For example, an expert cannot accept an engagement to verify a valuation if he contributed in any way to that valuation.

2.277 The principle of professional competence and due care imposes the following obligations on all professional experts:

- (a) to maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and
- (b) to act diligently in accordance with applicable technical and professional standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation, when providing professional services.

2.278 Knowledge and skills relate to the nature and level of expertise of an expert in the field to be evaluated. Experts need to have a recognised and relevant professional qualification regarding the subject of valuation and having recent experience in the valuation of the fields considered.

2.279 As part of assessing the knowledge and competence, undertakings may also consider:

- (a) knowledge of the expert's qualifications, membership of a professional body or industry association, license to practice, or other form of external recognition;
- (b) experience and knowledge of the type and category of item to be evaluated;
- (c) reputation and information delivered by others who are familiar with that expert's work; and
- (d) published papers or books written by that expert.

2.280 In order to assess the relevant professional qualification of organisations, the undertaking has to be able to demonstrate that the evaluations are carried out by individuals that satisfy the requirements of competence, capability and objectivity. The undertaking has to be able to demonstrate to the supervisor its assessment of the external expert. If an undertaking is not able to do so, the supervisor may need to ask for a new review by another expert.

2.281 Experts need to have the ability to exercise their competence in the given circumstances. Factors that influence this capability may include, for example, geographic location and the availability of time and resources.

2.282 If an undertaking, during or after the process of external valuation or verification, becomes aware of any facts which may jeopardize the independence of the experts, it assesses if that expert still fulfils the independence requirement. It communicates to the supervisory authority the fact that the assessment has been made and its results, including whether another valuation or verification by a different expert is needed.

Guideline 64 – Information to be provided to the supervisory authority on the external valuation or verification

The undertaking should provide the supervisory authority with all relevant information requested on external valuation or verification. The undertaking should include in this information, at least, the experts' written opinion on the valuation of the relevant asset or liability.

2.283 In most circumstances, if there are no other legal, statutory requirements or contractual arrangements governing the expert's work, the communication between the supervisory authority and the expert are channelled through the undertaking. The undertaking is responsible for providing the supervisory authority with the relevant information.

2.284 The expert performing external, independent valuation or verification has to document the appraisal work appropriately. Where appropriate, the supervisory authority may request an appraisal report.

Guideline 65 - Critical or important operational functions and activities

The undertaking should determine and document whether the outsourced function or activity is a critical or important function or activity on the basis of whether this function or activity is essential to the operation of the undertaking as it would be unable to deliver its services to policyholders without the function or activity.

2.285 A service provider is a third party and may be a supervised entity, an entity from the same group as the undertaking or not and it may be located inside the European Union (hereinafter "EU") as well as outside.

2.286 In principle, any functions and activities of an undertaking can be outsourced, but the AMSB retains ultimate responsibility for discharging its obligations.

2.287 While an outsourcing arrangement may be performed directly by the service provider, the service provider may sub-outsource to another provider if this is permitted by the contract agreed with the undertaking. While an undertaking

will not be a party to the sub-outsourcing agreement, it ensures that it is informed by the service provider of any sub-outsourcing, because the undertaking remains fully responsible for the activity or function outsourced and must ensure the service provided is satisfactorily performed.

- 2.288 An undertaking needs to decide whether an arrangement falls within the definition of outsourcing. Generally, for example, where an undertaking provides insurance services to its policyholders and certain elements of the delivery of those services are contracted to a third party, the arrangement is likely to be an outsourcing unless the policyholder has a direct contractual relationship with the third party for the delivery of those services. Any reliance on a third party for functions enabling the undertaking to provide those insurance services is also likely to be outsourcing.
- 2.289 However, not every provision of a function or service to an undertaking by a service provider will fall within the definition of outsourcing. Hiring a specialist consultant, for example, to provide one-off technical advice or one-off support for an undertaking's compliance, internal audit, accounting, risk management or actuarial functions does not normally constitute outsourcing. However, it may become outsourcing if an undertaking subsequently relies on that consultant to manage an internal function or service, e.g. when it is installed or becomes fully operational.
- 2.290 While it is not possible to determine a bright line it can be expected that, in broad terms, the more substantial or frequent the advice or service provided by a third party for an undertaking is, the more likely it is to fall within the definition of outsourcing.
- 2.291 In determining whether an outsourced function or activity is critical or important the undertaking has to take into account any definition or list of such functions or activities provided under national law or national administrative interpretation. Where functions or activities are partially outsourced it is relevant whether these outsourced parts are per se critical or important.
- 2.292 Examples of critical or important functions or activities include:
- a) the design and pricing of insurance products;
 - b) the investment of assets or portfolio management;
 - c) claims handling;
 - d) the provision of regular or constant compliance, internal audit, accounting, risk management or actuarial support;
 - e) the provision of data storage;
 - f) the provision of on-going, day-to-day systems maintenance or support;
and
 - g) the ORSA process.
- 2.293 The following activities cannot be considered critical or important operational functions or activities:

- a) the provision of advisory services to the undertaking and other services, which do not form part of the undertaking's insurance or reinsurance activities, such as legal advice, the training of personnel and the security of premises and personnel;
- b) the purchase of standardised services, including market information services and the provision of price feeds;
- c) the provision of logistical support, such as cleaning or catering; and
- d) the provision of elements of human resources support, such as recruiting temporary employees and processing the payroll.

Guideline 66 - Underwriting

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 should ensure that the activity of this intermediary is subject to the outsourcing requirements.

2.294 Underwriting is a main activity of any insurance undertaking. As such, underwriting is a critical or important operational function or activity. It is common in most Member States to have insurance intermediaries involved in the underwriting process. These are subject to [Insurance Intermediaries Directive (IMD)⁵]. However, where an insurance intermediary is mandated to write insurance business or to settle claims on behalf of the insurance undertaking, this is an outsourced service and, as such, the arrangement is caught by the Solvency II outsourcing requirements.

2.295 The typical intermediation activities of an insurance intermediary, i.e. introducing, proposing or carrying out other preparatory work for the conclusion of insurance contracts, or concluding such contracts, or assisting in the administration and performance of such contracts, in particular in the event of a claim, as set out in the IMD, these activities are not subject to the outsourcing requirements.

2.296 In the case of outsourcing of underwriting activities, the application of the outsourcing requirements needs to be analysed taking into consideration the specific requirements applicable under the IMD.

Guideline 67 - Intra-group outsourcing

If key functions are outsourced within the group, the responsible entity should document 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.

2.297 In case of intra-group outsourcing, the degree of flexibility may vary according to whether the service provider is, for example, in the same country as the undertaking or in a different geographical region.

⁵Official Journal L 009 , 15/01/2003 P. 0003

- 2.298 Nevertheless, the undertaking needs to assess whether and to what extent it should rely on functions and activities provided by a service provider in its group.
- 2.299 A written agreement has to be established, stipulating the duties and responsibilities of both parties. However, this could assume the form of a service level agreement since the arrangement is probably not subject to formal negotiations (unlike an outsourcing to an external service provider).
- 2.300 While the supervisory review process may take into account a group as a whole and the extent to which an entity within the group provides a service or function for other undertakings in the same group, the obligations remain with the individual undertaking as it is the authorised entity. While an undertaking may assign to another group member the carrying out of services or functions, it cannot absolve itself of responsibility for them and still has to manage the outsourcing arrangement robustly with, for example, suitable business contingency plans.

Guideline 68 - Outsourcing written policy

The undertaking that outsources or considers outsourcing should cover in its policy the undertaking's approach and processes for outsourcing from the inception to the end of the contract. This in particular should include:

- a. the criteria for determining whether a function or activity is critical or important;
- b. how a service provider of suitable quality is selected and how and how often his performance and results are assessed;
- c. the details to be included in the written agreement with the service provider taking into consideration the requirements laid down in the draft implementing measures;
- d. business contingency plans, including exit strategies for outsourced critical or important functions or activities.

- 2.301 On (b), the policy sets out the due diligence process to be carried out prior to deciding on an outsourcing arrangement. The matters to be covered include the financial and technical ability of the service provider and its capacity to perform the outsourcing; its control framework; and any conflict of interests, e.g. between service provider and undertaking or arrangements with competitors.
- 2.302 On (c), the policy also needs to address the conditions under which sub-outsourcing by a service provider is possible. In any case, if the sub-outsourced function is critical or important for the undertaking the sub-outsourced service needs to be approved by the undertaking.
- 2.303 The examination of an applicant service provider allows the undertaking to understand the main risks that might arise from the outsourcing, to identify the most suitable strategies for the mitigation or management of these risks and to ensure that the service provider has the ability, capacity and any authorisation required by law to perform the outsourced activities reliably and professionally. The conclusions are to be documented and reviewed by the undertaking at any time it considers relevant.

- 2.304 On (d), irrespective of the service provider's governance obligation to establish suitable contingency plans for the function outsourced by the undertaking, the undertaking needs to consider in its own contingency planning how, if needed, the outsourced can be taken over by a new service provider, or bring it back in-house, as appropriate.
- 2.305 The undertaking's AMSB approves all outsourced services of critical or important functions or relevant activities and regularly receives review reports on the performance of these outsourcing arrangements when they are operational.
- 2.306 An undertaking remains fully responsible for all outsourced functions and activities so needs to include in its system of governance a process for monitoring and reviewing the quality of the service provided. It is not sufficient for the service provider itself to have internal controls and a risk management system that covers the services performed. In order to ensure effective control of outsourced activities and manage the risks associated with the outsourcing, the undertaking needs to maintain the competence and ability within the undertaking to assess whether the service provider delivers according to contract.
- 2.307 As part of good management practice, an undertaking is expected to effectively monitor whether its service provider is in compliance with all the terms of their written agreement. If the service provider does not effectively carry out the functions or activities in compliance with the terms of the outsourcing agreement, appropriate actions must be taken. If, for example, a service provider is unwilling to cooperate with the undertaking's supervisory authorities, the undertaking will have to terminate the outsourcing agreement. In this context, where a service provider is located outside the EU, the undertaking needs to pay particular attention to whether the service provider's regulator or local laws and regulations might restrict access to information about the outsourced activity or function or to the service provider's premises.

Guideline 69 - Written notification to the supervisory authority

The undertaking should describe in its written notification to the supervisory authorities of any outsourcing of critical or important functions or activities and the service provider's name. When outsourcing concerns a key function, the notification should also include the name of the person in charge of the outsourced function or activities at the service provider.

2.308 The written notification of any outsourcing of a critical or important function which is also a key function is to include the name of the person who at the service provider is responsible for the outsourced function. Where this is the case, the supervisory authority expects the service provider to be able to demonstrate, at the request of the supervisory authority, that this person meets the fit and proper requirements and to provide the necessary information needed to assess the person who is fit and proper.

2.309 A notification of the supervisor is needed for the outsourcing of critical or important functions or activities, irrespective of whether the third party service

provider is authorised or not. Examples include where an undertaking has an underwriting outsourcing arrangement with an insurance intermediary subject to the IMD or it outsources functions to an insurance undertaking within its group.

2.310 The requirement for an undertaking to notify its supervisory authority in a timely manner prior to outsourcing any critical or important functions or activities does not necessarily mean that the supervisor has to approve or authorise the outsourcing. Rather, the prior notification presents an opportunity for the supervisor to discuss concerns with the undertaking, in case the outsourcing appears not to comply with the provisions of the Directive and the Delegated Act and the opportunity to object to the outsourcing if supervisory concerns cannot be dispelled.

2.311 'In a timely manner' constitutes a period of time sufficient for the supervisory authority to examine the proposed outsourcing before it comes into force. This could be at least six weeks before the outsourcing is due to come into effect.

2.312 'Subsequent material developments that entail further notification requirements' are all developments that are relevant for supervisory purposes, i.e. any circumstances that may give supervisors reasons to reassess the undertaking's compliance with the Directive or the Delegated Act or adversely affect the undertaking's ability to deliver its services to policyholders. This could, in particular, apply to material changes in the outsourcing arrangements, including any sub-outsourcings; a new service provider or major problems with the performance of the existing service provider, such as non-performance on account of business disruption, non-compliance with applicable laws and regulations, serious and repeated infringements of guidelines, inadequate risk management, insufficient granting of access to data and information or data or anything else that causes significant dissatisfaction to the undertaking or policyholders about the service.

Guideline 70 – Responsible entity

The participating insurance or reinsurance undertaking or the insurance holding company should identify the responsible entity, which is able to implement the governance requirements across the group, and report it to the group supervisor.

2.313 The entity responsible for the fulfilment requirement at group level is usually the parent undertaking, but depending on the structure and organization of the group this entity may be other than the parent undertaking.

Guideline 71 – Responsibilities for setting internal governance requirements

The responsible entity should set adequate internal governance requirements across the group appropriate to the structure, business and risks of the group and of its related entities, and should consider the appropriate structure and organization for risk management at group level, setting a clear allocation of responsibilities between all entities of the group.

The responsible entity should not impair the responsibilities of the AMSB of each entity in the group when setting up its own system of governance.

- 2.314 The entity responsible for fulfilling the governance requirements at group level is expected to verify that there is a clear allocation of responsibilities among all entities of the group to support an effective risk management process at group level.
- 2.315 Even if some or all of the governance requirements do not apply at the individual level for some entities belonging to an insurance group, namely holdings and other non-regulated entities, all governance requirements are applied to the coherent economic entity that in a holistic way aggregates all entities in the group (group level).

Guideline 72 – System of governance at group level

The responsible entity should:

- a. have 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. have 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. document and inform all the entities in the group about the tools used to identify, measure, monitor, manage and report all risks to which the group is exposed;
- d. take 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.

- 2.316 The AMSB of the entity responsible for fulfilling the governance requirements at group level assumes responsibility in terms of the establishment of group policies, review of the overall business activities, group strategies and policies. It understands not only the corporate organisation of the group but also the purpose of the group's different entities and the links and relationships among them. This includes understanding group-specific risks, intra-group transactions and how the group's funding, capital and risk profiles could be affected under normal and adverse circumstances.
- 2.317 The AMSB of the entity responsible for fulfilling the governance requirements at group level ensures that the different group entities, including the responsible entity, receive enough information for all of them to get a clear perception of the general aims and risks of the group. Any flow of significant information between entities relevant to the groups operational functioning should be documented and made accessible promptly, when requested, to the AMSB at group level, to the control functions and supervisors, as appropriate.
- 2.318 The AMSB of the entity responsible for fulfilling the governance requirements at group level ensures it keeps itself informed about the risks the groups' structure causes. This includes:
- a) information on major risk drivers; and

- b) regular reports assessing the group's overall structure and evaluating individual entity's activities compliance with the approved strategy.

2.319 In discharging its corporate governance responsibilities, the AMSB of the entity responsible for fulfilling the governance requirements at group level:

- a) establishes a governance structure that contributes to the effective oversight of the entities in the group, taking into account the nature, the scale and complexity of the different risks to which the group and its components are exposed;
- b) ensures the overall consistency of the group's governance structure taking into account the structures, activities and of the different entities of the group;
- c) sets and reviews the general strategies and policies of the group;
- d) has appropriate means to control that each entities in the group complies with all applicable corporate governance requirements;
- e) ensures that reporting system in the group are clear, transparent and appropriate in order to guarantee adequate and timely communications within the group.

Guideline 73 – Risks with significant impact at group level

The responsible entity should consider in its risk management system the risks both at individual and group level and their interdependencies, in particular:

- a. reputational risk and risks arising from intra-group transactions and risk concentrations, including contagion risk, 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;
- e. risks arising from other regulated entities.

2.320 The group is expected to have in place a process to identify the group's material risks, a comprehensive measurement system, a system of limits to manage exposures and other risk concentrations, and processes of stress testing and scenario and correlation analysis. Proper information systems and management reporting systems are essential for a sound risk management approach.

Guideline 74 – Concentration risk at group level

The responsible entity should ensure that there are processes and procedures in place to avoid concentration risks that may be a threat at group level.

2.321 The group needs to ensure that risk concentrations information is being collected on a consistent basis across the group. Processes and reporting requirements must be integrated into coherent assessments focused on the ORSA and building upon the group's own internal risk management.

Guideline 75 - Intra-group transactions

The responsible entity should ensure that the risk management system of the group and the individual undertakings include processes and reporting procedures for identifying, measuring, monitoring, managing and reporting of intra-group transactions, including significant and very significant intra-group transactions as referred in Solvency II.

2.322 The governance system needs to assure a sound management of IGT: proper information systems and management reporting mechanisms must be in place to allow supervisory authorities to monitor IGT and their management.

2.323 Consideration needs to be given to any unusual or excessive activity in individual locations or legal entities, on accurate measurement and accounting and on profit distribution which has to be properly addressed in the context of the ORSA.

Guideline 76 – Group risk management

The responsible entity should support 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 entity are or might be exposed to. The responsible entity should ensure that the structure and organization of the group risk management do not impair the undertaking's legal ability to fulfil its legal, regulatory and contractual obligations.

2.324 This guideline needs to be read in conjunction with guideline 14 Role of the AMSB in the risk management system.

2.325 The entity responsible for fulfilling the governance requirements at group level is expected to assess how and to what extent all risks within the group are effectively identified, measured, managed and monitored. This assessment will be supported by appropriate documentation on the structure, organization and centralization of the group risk management system.

II. Guidelines on own risks and solvency assessment

1. Guidelines

Introduction

- 1.1 According to Article 16 of Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (hereinafter "EIOPA Regulation")⁶, EIOPA issues these Guidelines addressed to the supervisory authorities on how to proceed with the application 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 (hereinafter "Solvency II")⁷.
- 1.2 These Guidelines are based on Articles 41, 44, 45 and Article 246 of Solvency II.
- 1.3 Supervisory authorities are expected to ensure that undertakings take a forward looking view on the risks to which they are exposed.
- 1.4 The Guidelines focus on what is to be achieved by the own risk and solvency assessment (hereinafter "ORSA"), rather than on how it is to be performed. For example, since the assessment of overall solvency needs represents the undertaking's own view of its risk profile, and the capital and other means needed to address these risks, the undertaking should decide for itself how to perform this assessment given the nature, scale and complexity of the risks inherent in its business.
- 1.5 EIOPA acknowledges and supports the developments and achievements on a global scale and national level outside the European Union with regard to setting standards for ORSA with a forward looking perspective. However, EIOPA does not expect that supervisory authorities in third countries apply these Guidelines. Nevertheless, the Guidelines are subject to equivalence analysis. When referring to group structures or group level, the Guidelines apply to European Economic Area (hereinafter "EEA") groups only. The guidelines apply to branches established within the community and belonging to insurance or reinsurance undertakings with their head office situated outside the community and performing business referred to in the first subparagraph of Article 2(1) of Solvency II.
- 1.6 It is crucial that the administrative, management or supervisory body (hereinafter "AMSB") of the undertaking is aware of all material risks the undertaking faces, regardless of whether the risks are captured by the Solvency Capital Requirement calculation and whether they are quantifiable or not. It is

⁶ OJ L 331, 15.12.2010, p. 48–83.

⁷ OJ L 335, 17.12.2009, p.1-155.

also vital that the AMSB takes an active role in the ORSA by directing the process and challenging the outcome.

- 1.7 In case a group wishes to apply for the use of a single group ORSA document, this requires a high level of consistency in processes across the group.
- 1.8 The Guidelines apply to both individual undertakings and at the level of the group. Additionally, the Guidelines address issues relevant to the group specificities of the ORSA, in particular on account of specific risks to the group or risks that could be less relevant at individual level than at group level.
- 1.9 The relevant Guidelines for individual undertakings apply *mutatis mutandis* to the group ORSA. Additionally, groups need to take into consideration the group specific Guidelines.
- 1.10 For the purpose of these Guidelines, the following definitions have been developed:
 - 'group level' means a coherent economic entity (holistic view) comprising all entities in the group as referred to in the Guidelines on the system of governance;
 - 'the responsible entity' is the entity responsible for fulfilling the governance requirements at group level;
 - 'group ORSA' means the ORSA undertaken at group level;
 - 'single ORSA document' means the single ORSA undertaken at the level of the group and at the level of any subsidiary of the group on the same reference date and period formalised in one document when supervisory agreement is given to do so.
- 1.11 If not defined in these Guidelines, the terms have the meaning defined in the legal acts referred to in the introduction.
- 1.12 The Guidelines shall apply from 1 January 2016.

Section 1: General considerations

Guideline 1 – Proportionality

1.13 The undertaking should develop for the ORSA its own processes with appropriate and adequate techniques, tailored to fit into its organisational structure and risk-management system and taking into consideration the nature, scale and complexity of the risks inherent to the business.

Guideline 2 – Role of the AMSB: top-down approach

1.14 The AMSB of the undertaking should take an active part in the ORSA, including steering, how the assessment is to be performed and challenging the results.

Guideline 3 – Documentation

1.15 The undertaking should have at least the following documentation on the ORSA:

- a) the policy for the ORSA;
- b) record of each ORSA;
- c) an internal report on each ORSA;
- d) a supervisory report of the ORSA.

Guideline 4 – Policy for the ORSA

1.16 The AMSB of the undertaking should approve the policy for the ORSA. This policy should include at least:

- a) a description of the processes and procedures in place to conduct the ORSA;
- b) a consideration of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs;
- c) a description of the methods and methodologies including information on:
 - i. how and how often stress tests, sensitivity analyses, reverse stress tests or other relevant analyses are to be performed;
 - ii. data quality standards;
 - iii. the frequency of the assessment itself and the justification of its adequacy particularly taking into account the undertaking's risk profile and the volatility of its overall solvency needs relative to its capital position ;
 - iv. the timing for the performance of the ORSA and the circumstances which would trigger the need for an ORSA outside of the regular time-scales.

Guideline 5 – Record of each ORSA

1.17 The undertaking should evidence and document each ORSA and its outcome.

Guideline 6 – Internal reporting on the ORSA

- 1.18 The undertaking should communicate to all relevant staff at least the results and conclusions of the ORSA, once the process and the results have been approved by the AMSB.

Section 2: Specific features regarding the performance of the ORSA

Guideline 7 – Assessment of the overall solvency needs

- 1.19 The undertaking should provide a quantification of the capital needs and a description of other means needed to address all material risks irrespective of whether the risks are quantifiable or not.
- 1.20 Where appropriate, the undertaking should subject the identified material risks to a sufficiently wide range of stress test or scenario analyses in order to provide an adequate basis for the assessment of the overall solvency needs.

Guideline 8 – Forward-looking perspective of the overall solvency needs assessment

- 1.21 The undertaking should ensure that its assessment of the overall solvency needs is forward-looking, including a medium term or long term perspective as appropriate.

Guideline 9 – Valuation and recognition bases of the overall solvency needs

- 1.22 The undertaking should, if it uses recognition and valuation bases that are different from the Solvency II bases in the assessment of its overall solvency needs, explain how the use of such different recognition and valuation bases ensures better consideration of the specific risk profile, approved risk tolerance limits and business strategy of the undertaking, while complying with the requirement for a sound and prudent management of the business.
- 1.23 The undertaking should quantitatively estimate the impact on the overall solvency needs assessment of the different recognition and valuation bases in those cases where recognition and valuation bases that are different from the Solvency II bases have been used in the assessment of its overall solvency needs.

Guideline 10 – Continuous compliance with regulatory capital requirements

- 1.24 The undertaking should analyse whether it complies on a continuous basis with the Solvency II regulatory capital requirements and as part of this assessment it should include at least:
- a) the potential future material changes in its risk profile;
 - b) the quantity and quality of its own funds over the whole of its business planning period;
 - c) the composition of own funds across tiers and how this composition may change as a result of redemption, repayment and maturity dates during its business planning period.

Guideline 11 – Continuous compliance with technical provisions

- 1.25 The undertaking should require the actuarial function of the undertaking to:
- a) provide input as to whether the undertaking would comply continuously with the requirements regarding the calculation of technical provisions;
 - b) identify potential risks arising from the uncertainties connected to this calculation.

Guideline 12 – Deviations from assumptions underlying the Solvency Capital Requirement calculation

- 1.26 The undertaking should assess whether its risk profile deviates from the assumptions underlying the Solvency Capital Requirement calculation and whether these deviations are significant. The undertaking may as a first step perform a qualitative analysis and if that indicates that the deviation is not significant, a quantitative assessment is not required.

Guideline 13 – Link to the strategic management process and decision-making framework

- 1.27 The undertaking should take into account the results of the ORSA and the insights gained during the process of this assessment in at least:
- a) its capital management;
 - b) its business planning;
 - c) its product development and design.

Guideline 14 – Frequency

- 1.28 The undertaking should perform the ORSA at least annually.

Section 3: Specificities of the group in the ORSA

Guideline 15 – Scope of group ORSA

- 1.29 The responsible entity should design the group ORSA to reflect the nature of the group structure and its risk profile. All of the entities that fall within the scope of group supervision should be included within the scope of the group ORSA. This should include insurance, reinsurance and non-(re)insurance undertakings, and both regulated and non-regulated entities, situated in the EEA and outside the EEA.

Guideline 16 – Reporting to the supervisory authorities

- 1.30 The document sent to the group supervisor with the outcome of the group ORSA should be in the same language as the group regular supervisory reporting.
- 1.31 If a single ORSA has been approved and, where any of the subsidiaries has its head office in a Member State whose official languages are different from the languages in which the single ORSA document is reported, the supervisory authority concerned may, after consulting the group supervisor, the college of supervisors and the group itself, require the undertaking to include a translation of the part of the ORSA information concerning the subsidiary into an official language of that Member State.

Guideline 17 – Group specificities on overall solvency needs

- 1.32 The responsible entity should adequately assess the impact of all group specific risks and interdependencies within the group and the impact of these risks and interdependencies on the overall solvency needs. The responsible entity should take into consideration the specificities of the group and the fact that some risks may be scaled up at the level of the group.
- 1.33 In accordance with Guideline 5 on the record of each ORSA, the responsible entity should include in the record of the group ORSA at least a description on how the following factors were taken into consideration for the assessment of overall solvency needs:
- a) the identification of the possible sources of capital within the group and identification of potential needs for additional capital;
 - b) the assessment of availability, transferability or fungibility of capital;
 - c) references to any envisaged transfer of capital within the group, which would have a material impact on any entity of the group, and its consequences;
 - d) alignment of individual strategies with the ones established at the level of the group;
 - e) specific risks the group could be exposed to.

Guideline 18 - Group specificities on the continuous compliance with regulatory capital requirements

- 1.34 In accordance with Guideline 5 on the record of each ORSA, the responsible entity should include in the record of the group ORSA at least a description on how the following factors were taken into consideration for the assessment of continuous compliance with regulatory requirements:
- a) the identification of the sources of own funds within the group and if there is a need for additional own funds;
 - b) the assessment of availability, transferability or fungibility of own funds;
 - c) references to any planned transfer of own funds within the group, which would have a material impact on any entity of the group, and its consequences;
 - d) alignment of individual strategies with the ones established at the level of the group;
 - e) specific risks the group could be exposed to.

Guideline 19 – Specific requirements for a single ORSA document

- 1.35 When applying to submit a single ORSA document, the responsible entity should provide an explanation of how the subsidiaries are covered and how the AMSBs of the subsidiaries are involved in the assessment process and approval of the outcome.

Guideline 20 – Internal model users

- 1.36 In the case of an internal model, the responsible entity should describe in the group ORSA policy which entities within the group do not use the internal model

to calculate their Solvency Capital Requirement and explain why this is the case.

Guideline 21 – Integration of related third-country insurance and re-insurance undertakings

1.37 In the assessment of the group overall solvency needs, the responsible entity should include the risks of the business in third countries in a consistent manner as it does for European Economic Area-business with special attention to the assessment of transferability and fungibility of capital.

Compliance and Reporting Rules for the Guidelines on System of Governance and Guidelines on own risk and solvency assessment

1.38 This document contains Guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16(3) of the EIOPA Regulation, competent authorities and financial institutions must make every effort to comply with guidelines and recommendations.

1.39 Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.

1.40 Competent authorities shall confirm to EIOPA whether they comply or intend to comply with these Guidelines, with reasons for non-compliance, within two months after the issuance of the translated versions.

1.41 In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.

Final Provision on Reviews

1.42 The present Guidelines shall be subject to a review by EIOPA.

2. Explanatory text on Guidelines on own risks and solvency assessment

Guideline 1 – Proportionality

The undertaking should develop for the ORSA its own processes with appropriate and adequate techniques, tailored to fit into its organisational structure and risk-management system and taking into consideration the nature, scale and complexity of the risks inherent to the business.

- 2.1. Article 45 of Solvency II requires the undertaking to perform a regular ORSA as part of the risk-management system. The main purpose of the ORSA is to ensure that the undertaking engages in the process of assessing all the risks inherent to its business and determines the corresponding capital needs. To achieve this, an undertaking needs adequate and robust processes to assess, monitor and measure its risks and overall solvency needs, and also to ensure that the output from the assessment forms an important part of the decision making processes of the undertaking. Conducting an assessment of the overall solvency needs properly involves input from across the whole undertaking. The ORSA is not complied with by producing only a report or by filling templates.
- 2.2. The design of the overall solvency needs assessment reflects the way the undertaking proposes to manage the risks that it faces through capital needs or other risk mitigation techniques. This takes into consideration the risk profile, the approved risk tolerance limits and the business strategy. The determination of the overall solvency needs is expected to contribute to assessments of whether to retain or transfer risks, of how best to optimise the undertaking's capital management and of how to establish the appropriate premium levels. It is also expected to provide input into other strategic decisions.
- 2.3. An undertaking cannot simply rely on the regulatory capital requirements to be adequate for its business and risk profile. An essential part of risk management is the undertaking performing its own assessment of the own funds (including amount, quality, etc.) it needs to hold in view of the particular risk exposure and business objectives. Since the risks the undertaking is exposed to translate into solvency needs, looking at risk and capital management separately is not appropriate.
- 2.4. As the overall solvency needs assessment is the undertaking's own analysis, undertakings have flexibility in this assessment. However, supervisory expectations are more specific with regard to the continuous compliance with the regulatory capital and technical provisions and the assessment of any

deviation between the undertaking's risk profile and the assumptions underlying the SCR calculation.

- 2.5. ORSA will also allow the undertaking to determine the adequacy of its regulatory capital position. The undertaking is required to ensure that it can meet the regulatory capital requirements in the form of the minimum capital requirement (MCR) and the solvency capital requirement (SCR).
- 2.6. The undertaking is also expected to consider whether the SCR, calculated with the standard formula or an internal model, would be appropriate according to the undertaking's risk profile.
- 2.7. The ORSA may call for the performance of tasks that the undertaking has already performed in a different context in which case no duplication of tasks is required but the result reached is to be taken into account in the ORSA.
- 2.8. An undertaking's assessment of its overall solvency needs does not necessarily call for the use of a complex approach. The methods employed may range from simple stress tests to more or less sophisticated economic capital models. Where such economic capital models are being used, they do not need to meet the requirements for the use of internal models for the calculation of the SCR in accordance with Articles 112 to 126.
- 2.9. Proportionality is to be reflected not only in the level of complexity of the methods used but also in the frequency of the performance of the ORSA by the undertaking and in the level of granularity of the different analyses to be included in the ORSA.

Guideline 2 – Role of the AMSB: top-down approach

The AMSB of the undertaking should take an active part in the ORSA, including steering, how the assessment is to be performed and challenging the results.

- 2.10. The ORSA is a very important tool for the AMSB of the undertaking providing it with a comprehensive picture of the risks the undertaking is exposed to or could face in the future. It has to enable the AMSB to understand these risks and how they translate into capital needs or alternatively require risk mitigation techniques.
- 2.11. The AMSB challenges the identification and assessment of risks, and any factors to be taken into account. It also gives instructions on management actions to be taken if certain risks were to materialise.
- 2.12. As part of the ORSA the AMSB challenges the assumptions behind the calculation of the SCR to ensure they are appropriate in view of the assessment of the undertaking's risks.

- 2.13. Taking into account the insights gained from the ORSA, the AMSB approves the long and short term capital planning, whilst considering the business and risk strategies it has decided upon for the undertaking. This plan includes alternatives to ensure that capital requirements can be met even under unexpectedly adverse circumstances.

Guideline 3 – Documentation

The undertaking should have at least the following documentation on the ORSA:

- a) the policy for the ORSA;
- b) record of each ORSA;
- c) an internal report on each ORSA;
- d) a supervisory report of the ORSA.

- 2.14. Documenting information does not necessarily require that new or fully separate reports or documents are drafted; it can be sufficient to refer to existing documents where these contain the relevant information and just record additional information if and insofar as this is necessary to present the full picture.

Guideline 4 – Policy for the ORSA

The AMSB of the undertaking should approve the policy for the ORSA. This policy should include at least:

- a) a description of the processes and procedures in place to conduct the ORSA;
- b) a consideration of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs;
- c) a description of the methods and methodologies including information on:
 - i. how and how often stress tests, sensitivity analyses, reverse stress tests or other relevant analyses are to be performed;
 - ii. data quality standards;
 - iii. the frequency of the assessment itself and the justification of its adequacy particularly taking into account the undertaking's risk profile and the volatility of its overall solvency needs relative to its capital position;
 - iv. the timing for the performance of the ORSA and the circumstances which would trigger the need for an ORSA outside of the regular time-scales.

- 2.15. The AMSB ensures that the ORSA is appropriately designed and implemented.

- 2.16. According to Article 41(3) undertakings are required to have a written policy on risk management. As risk management includes the ORSA, undertakings have to develop a policy for ORSA.

Guideline 5 – Record of each ORSA

The undertaking should evidence and document each ORSA and its outcome.

- 2.17. The undertaking records the performance of each ORSA and the assessment of any deviations in its risk profile from the assumptions underlying the SCR calculation to a level of detail that enables a third party to evaluate the assessments.
- 2.18. The record of each ORSA is therefore expected to include:
- a) The individual risk analysis, including a description and explanation of the risks considered;
 - b) The links between the risk assessment and the capital allocation process and an explanation of how the approved risk tolerance limits were taken into account;
 - c) An explanation of how risks not covered with own funds are managed;
 - d) A technical specification of the approach used for the ORSA assessment, including a detailed description of the key structure, together with a list and justification of the assumptions underlying the approach used, the process used for setting dependencies, if any, and the rationale for the confidence level chosen, if any, a description of stress tests and scenario analyses employed and the way their results were taken into account, and an explanation of how parameter and data uncertainty were assessed;
 - e) An amount or range of values for the overall solvency needs over a one-year-period, as well as for a longer period and a description of how the undertaking expects to address the needs;
 - f) Action plans arising from the assessment and the rationales for them. This requires the documentation to cover any strategies for raising additional own funds where necessary and the proposed timing for actions to improve the undertaking's financial condition;
 - g) Details on the conclusions and the rationale for them from the assessment of the continuous compliance with the requirements of regulatory capital and technical provisions;

- h) For undertakings that would use an internal model to calculate the SCR, a description of the changes made to the internal model **under pre-application process during this process if any**;
- i) The identification and explanation of the differences between the undertaking's risk profile and the assumptions underlying the calculation of the SCR. Where the deviations are considered to be significant resulting in either an under or an overestimation of the SCR, the internal documentation addresses how the undertaking has reacted or will react;
- j) A description of what internal and external factors were taken into consideration in the forward-looking perspective;
- k) Details of any planned relevant management actions, including an explanation and a justification for these actions, and their impact on the assessment; and
- l) A record of the challenge process performed by the AMSB.

Guideline 6 – Internal reporting on the ORSA

The undertaking should communicate to all relevant staff at least the results and conclusions of the ORSA, once the process and the results have been approved by the AMSB.

- 2.19. The information communicated to the AMSB has to be sufficiently detailed to enable it to use it in its strategic decision-making process. And the information communicated to relevant staff has to be sufficiently detailed to enable staff to take any necessary follow-up actions.
- 2.20. The internal report developed by the undertaking could be the basis of the supervisory report of the ORSA. If the undertaking considers that the internal report has an appropriate level of detail also for supervisory purposes then the same report may be submitted to the national supervisory authority.

Guideline 7 – Assessment of the overall solvency needs

The undertaking should provide a quantification of the capital needs and a description of other means needed to address all material risks irrespective of whether the risks are quantifiable or not.

Where appropriate, the undertaking should subject the identified material risks to a sufficiently wide range of stress test or scenario analyses in order to provide an adequate basis for the assessment of the overall solvency needs.

- 2.21. In its assessment of the overall solvency needs an undertaking could decide not to use capital as a buffer for all its quantifiable risks but to manage and mitigate those risks by other means. The assessment covers all material risks,

including non-quantifiable risks like reputational risk or strategic risk, amongst others. The assessment could take several forms. It could be pure quantification based on quantitative methodologies or an estimated value or range of values which are based on particular assumptions or scenarios, or it could be more or less judgemental. It is, however, required that the undertaking demonstrates the rationale for the assessment.

- 2.22. When an insurance undertaking belongs to a group, its ORSA has to consider all group risks that may impact materially the individual entity.
- 2.23. As the risk profile is influenced by the risk mitigation techniques used by the undertaking, the assessment of the impact and the effectiveness of reinsurance and other risk mitigation techniques play a role in the ORSA. Where there is no effective risk transfer this has to be taken into account in the assessment of the overall solvency needs.
- 2.24. After identifying all the risks it is exposed to, the undertaking takes a decision on whether they will be covered with capital or managed with risk mitigation tools or both.
- 2.25. If the risks are to be covered by capital, there is a need to estimate the risks and identify the level of materiality. For material risks, the undertaking has to determine the capital required and explain how they will be managed.
- 2.26. If the risks are managed with risk mitigation techniques, the undertaking explains which risks are going to be managed by which technique and the underlying reasons.
- 2.27. The assessment needs to cover whether the undertaking currently has sufficient financial resources and realistic plans for how to raise additional capital if and when required, for example on account of the business strategy or business plan. In assessing the sufficiency of its financial resources the undertaking has to take into account the quality and volatility of its own funds with particular regard to their loss-absorbing capacity under different scenarios.
- 2.28. Conducting an assessment of the overall solvency needs properly involves input from across the whole undertaking. One difference from the SCR calculation is that for the overall solvency needs assessment the undertaking considers all material risks, including long term risks, it could face within the timeframe in the medium term or, where relevant, in the long term. Although the SCR only takes quantifiable risks into account, the undertaking is expected to identify and assess the extent to which non-quantifiable risks are part of its risk profile and to ensure that they are properly managed.
- 2.29. The assessment of the overall solvency needs is expected to at least:

- a) Reflect the material risks arising from all assets and liabilities, including intra-group and off-balance sheet arrangements;
- b) Reflect the undertaking's management practices, systems and controls including the use of risk mitigation techniques;
- c) Assess the quality of processes and inputs, in particular the adequacy of the undertaking's system of governance, taking into consideration risks that may arise from inadequacies or deficiencies;
- d) Connect business planning to solvency needs;
- e) Include explicit identification of possible future scenarios;
- f) Address potential external stress; and
- g) Use a valuation basis that is consistent throughout the overall solvency needs assessment.

2.30. When assessing the overall solvency needs, an undertaking also takes into account management actions that may be adopted in adverse circumstances. When relying on such prospective management actions, an undertaking assesses the implications of taking these actions, including their financial effect, and takes into consideration any preconditions that might affect the efficacy of the management actions as risk mitigators. The assessment also addresses how any management actions would be enacted in times of financial stress.

2.31. As internal model users would be required to develop and carry out, on a regular basis, their own stress tests and scenario analyses as part of the complying with the validation standards set out in Article 124 of Solvency II, they may need to develop further stresses and scenarios for the ORSA. The process for setting the stress and scenarios should be consistent with internal model requirements.

2.32. Where the undertaking uses the standard formula as a baseline for its assessment of its overall solvency needs, it is expected to demonstrate that this is appropriate to the risks inherent in its business and reflects its risk profile.

2.33. In the case of internal model users, the explanations and justifications that would be required for the use of an internal model can be used, if appropriate in the context of the ORSA. Nevertheless specific explanations need to cover the use of a different recognition or valuation basis in the ORSA to that used in the internal model to calculate the SCR.

assessment

The undertaking should ensure that its assessment of the overall solvency needs is forward-looking, including a medium term or long term perspective as appropriate.

- 2.34. The analysis of the undertaking's ability to continue as a going concern and the financial resources needed to do so over a time horizon of more than one year is an important part of the ORSA.
- 2.35. Unless an undertaking is in a winding-up situation, it has to consider how it can ensure that it can continue as a going concern. In order to do this successfully, it does not only have to assess its current risks but also the risks it will or could face in the long term. That means that, depending on the complexity of the undertaking's business, it may be appropriate to perform long term projections of the business, which are in any case a key part of any undertaking's financial planning. This might include business plans and projections of the economic balance sheet as well as variation analysis to reconcile these two items. These projections are required to feed into the ORSA in order to enable the undertaking to form an opinion on its overall solvency needs and own funds in a forward looking perspective.
- 2.36. The undertaking needs to project its capital needs at least over its business planning period, taking into account medium and long term risk, as appropriate. This projection is to be made taking into consideration any likely changes to the risk profile and business strategy over the projection period and the sensitivity of the assumptions used.
- 2.37. If the undertaking generates a new business plan or revises an existing business plan, these changes need to be reflected in the ORSA taking into account the new risk profile, the business volume and the business mix that is expected. In order to provide a proper basis for decision-making and to identify material risks and the consequences for the overall solvency needs by changes to the business plan, a range of possible scenarios have to be tested.
- 2.38. An undertaking also identifies and takes into account external factors that could have an adverse impact on its overall solvency needs or on its own funds. Such external factors could include changes in the economic conditions, the legal framework, the fiscal environment, the insurance market, technical developments that have an impact on underwriting risk, or any other probable relevant event. The undertaking will need to consider as part of its capital management plans and capital projections how it might respond to unexpected changes in external factors.

Guideline 9 – Valuation and recognition bases of the overall solvency needs

The undertaking should, if it uses recognition and valuation bases that are different

from the Solvency II bases in the assessment of its overall solvency needs, explain how the use of such different recognition and valuation bases ensures better consideration of the specific risk profile, approved risk tolerance limits and business strategy of the undertaking, while complying with the requirement for a sound and prudent management of the business.

The undertaking should quantitatively estimate the impact on the overall solvency needs assessment of the different recognition and valuation bases in those cases where recognition and valuation bases that are different from the Solvency II bases have been used in the assessment of its overall solvency needs.

2.39. The quantitative estimate of the impact includes all balance sheet effects. The diversification effects between risks (correlations) are also considered in this assessment. In this the undertaking is not bound to use the correlations included in the standard formula, but may employ others considered to be more suitable to its specific business and its risk profile.

Guideline 10 – Continuous compliance with regulatory capital requirements

The undertaking should analyse whether it complies on a continuous basis with the Solvency II regulatory capital requirements and as part of this assessment it should include at least:

- a) the potential future material changes in its risk profile;
- b) the quantity and quality of its own funds over the whole of its business planning period;
- c) the composition of own funds across tiers and how this composition may change as a result of redemption, repayment and maturity dates during its business planning period.

2.40. For the assessment of the compliance on a continuous basis with the regulatory capital and technical provisions requirements, the recognition and valuation bases have to be in line with the relevant principles provided by Solvency II.

2.41. Changes in an undertaking's risk profile may affect the future MCR and SCR calculations and this needs to be taken into consideration in the capital management process.

2.42. The assessment also needs to consider the changes to the own funds position that might occur in stressed situations. The undertaking is expected to carry out stress tests and scenario analyses to assess the resilience of the business.

2.43. Capital planning includes projections of capital requirements and own funds over the planning period (and may include the need to raise new own funds). It is up to each undertaking to decide for itself the reasonable methods,

assumptions, parameters, dependencies or levels of confidence to be used in the projections.

- 2.44. As part of the business and capital planning processes, an undertaking will need to regularly carry out stress tests, reverse stress-tests, as well as scenario analyses to feed into its ORSA. The stress testing scope and frequency has to be proportionate.
- 2.45. When considering the quantity, quality and composition of its own funds, the undertaking has to consider the following: the mix between basic own funds and ancillary own funds, and also between tiers, the relative quality of the own funds and their loss absorbing capacity.
- 2.46. When considering future own fund requirements the undertaking has to consider:
- a) Capital management including at least issuance, redemption or repayment of capital instruments, dividends and other distributions of income or capital, and calls on ancillary own fund items. This has to include both projected changes and contingency plans in the result of a stressed situation;
 - b) The interaction between the capital management and its risk profile and its expected and stressed evolution;
 - c) If required, its ability to raise own funds of an appropriate quality and in an appropriate timescale. This has to have regard to: its access to capital markets; the state of the markets; its dependence on a particular investor base, investors or other members of its group; and the impact of other undertakings seeking to raise own funds at the same time; and
 - d) How the average duration of own fund items (contractual, maturity or call dates) relates to the average duration of its insurance liabilities and future own funds' needs.
- 2.47. The undertaking also assesses and identifies relevant compensating measures and offsetting actions it could realistically take to restore or improve capital adequacy or its cash flow position after some future stress events.

Guideline 11 – Continuous compliance with technical provisions

The undertaking should require the actuarial function of the undertaking to:

- a) provide input as to whether the undertaking would comply continuously with the requirements regarding the calculation of technical provisions;
- b) identify potential risks arising from the uncertainties connected to this calculation.

- 2.48. Assessing whether the requirements relating to technical provisions are being complied with continuously requires processes and procedures relating to a regular review of the calculation of the technical provisions to be in place.
- 2.49. The input regarding the compliance with requirements and the risks arising from the calculation of technical provisions has to be in line with the information contained in the annual report of the actuarial function.

Guideline 12 – Deviations from assumptions underlying the Solvency Capital Requirement calculation

The undertaking should assess whether its risk profile deviates from the assumptions underlying the Solvency Capital Requirement calculation and whether these deviations are significant. The undertaking may as a first step perform a qualitative analysis and if that indicates that the deviation is not significant, a quantitative assessment is not required.

- 2.50. The assessment of the significance with which the risk profile of the undertaking deviates from the assumptions underlying the SCR calculation ensures that the undertaking understands the assumptions underlying its SCR calculation and considers whether those assumptions are appropriate. To do this, the undertaking will have to compare those assumptions with its own understanding of its risk profile. This process needs to prevent an undertaking from simply relying upon regulatory capital requirements as being adequate for its business.
- 2.51. In order to help standard formula users in the assessment, information on the assumptions on which the SCR calculation is based will be made available to undertakings.
- 2.52. The undertaking has to assess the significance of deviations of its specific risk profile from the relevant assumptions underlying the (sub) modules of the SCR calculation the correlations between the (sub) modules and the building blocks of the (sub) modules.
- 2.53. Due consideration needs to be given to the following differences between the undertaking's risk profile and the assumptions underlying the SCR calculation: differences due to risks that are not considered in the standard formula and differences due to risks that are either under or overestimated by the standard formula compared to the risk profile. The assessment process is expected to include:
- a) An analysis of the risk profile and an assessment of the reasons why the standard formula is appropriate, including a ranking of risks;

- b) An analysis of the sensitivity of the standard formula to changes in the risk profile, including the influence of reinsurance arrangements, diversification effects and the effects of other risk mitigation techniques;
- c) An assessment of the sensitivities of the SCR to the main parameters, including undertaking-specific parameters;
- d) An elaboration on the appropriateness of the parameters of the standard formula or of undertaking-specific parameters;
- e) An explanation why the nature, scale and complexity of the risks justify any simplifications used; and
- f) An analysis of how the results of the standard formula are used in the decision making process.

2.54. If the outcome of this qualitative and quantitative assessment is that there are significant deviations between the risk profile of the undertaking and the SCR calculation, the undertaking would be expected to consider how this could be addressed. It could decide to align its risk profile with the standard formula, to apply for undertaking-specific parameters, where this is allowed, or to develop a (partial) internal model. Alternatively, the undertaking could decide to de-risk.

2.55. It is unlikely that the undertaking can determine whether the risk profile deviates significantly from the assumptions underlying the SCR by comparing the amount of the overall solvency needs as identified through the ORSA risks with the SCR. Since overall solvency needs and SCR can be calculated on different bases and may include different items, the amounts produced will not be readily comparable. There are a number of reasons that could account for the differences that have nothing to do with deviations of the risk profile, such as:

- a) The undertaking may operate at a different confidence level or risk measure for business purposes compared to the assumptions on which the SCR calculation is based. For instance, it may choose to hold own funds for rating purposes, which represents a higher confidence level than that used to calibrate the SCR.
- b) The undertaking may use a time horizon for its business planning purposes that differs from the time horizon underlying the SCR.
- c) In the ORSA the undertaking may consider any agreed management actions that could influence the risk profile.

Internal model users

2.56. The undertaking ensures that the internal model plays an important role in the ORSA as set out in Article 120 of Solvency II.

Internal model users – Overall Solvency Needs

2.57. According to Article 120 of Solvency II, as part of the use test, internal models would need to play an important role in the ORSA. This does not necessarily mean that the assessment of the overall solvency needs would be accomplished solely by running the internal model. In this context, the ORSA includes the assessment of:

- a) the impact of the excluded material risks or major lines of business would have on the solvency position in the case of partial internal model;
- b) the interrelationship between risks which are in and outside the scope of the model; and
- c) the identification of risks other than those covered by the internal model, which may trigger a change to the internal model.

Guideline 13 – Link to the strategic management process and decision-making framework

The undertaking should take into account the results of the ORSA and the insights gained during the process of this assessment in at least:

- a) its capital management;
- b) its business planning;
- c) its product development and design.

2.58. In deciding on the business strategy, the undertaking has to take into account the output from the ORSA.

2.59. As an integral part of the business strategy, an undertaking needs to have in place its own strategies for managing its overall solvency needs and regulatory capital requirements and integrating this with the management of all material risks to which it is exposed. Hence the ORSA feeds into the management of the business, in particular into the strategic decisions, operational and management processes.

2.60. The ORSA is required to reflect the business strategy. Hence, when performing the ORSA the undertaking takes into account the business strategy and any strategic decisions influencing the risk situation and regulatory capital requirement as well as overall solvency needs. On the other hand, the AMSB needs to be aware of the implications that strategic decisions have on the risk profile and regulatory capital requirements and overall solvency needs of the undertaking and to consider whether these effects are desirable, affordable and feasible given the quantity and quality of its own funds. Any strategic or other

major decisions that may materially affect the risk or own funds' position of the undertaking need to be considered through the ORSA before such a decision is taken. This does not necessarily imply a full performance of the ORSA: the undertaking considers how the output of the last assessment of the overall solvency needs would change if certain decisions were taken and how these decisions would affect the regulatory capital requirements.

- 2.61. Where the undertaking is relying on management processes, in particular systems and controls, in order to mitigate risks, it considers the effectiveness of those systems and controls in a stress situation.

Guideline 14 – Frequency

The undertaking should perform the ORSA at least annually.

- 2.62. The ORSA has to be performed on a regular basis and in any case immediately after any significant change in the risk profile of the undertaking.

- 2.63. The undertaking decides when to perform the regular ORSA which, as a rule, needs to use the same reference date as the SCR calculation but different reference dates could be acceptable if there has been no material change in the risk profile between them.

- 2.64. The ORSA performed after any significant change of the risk profile is called a non-regular ORSA. In this regard undertakings are expected to use their experience from stress tests and scenario analyses to determine whether changes in external factors could impact the undertaking's risk profile significantly.

- 2.65. Such changes may follow from internal decisions and external factors. Examples are: the start-up of new lines of business; major amendments to approved risk tolerance limits or reinsurance arrangements, internal model changes, portfolio transfers or major changes to the mix of assets.

Guideline 15 – Scope of group ORSA

The responsible entity should design the group ORSA to reflect the nature of the group structure and its risk profile. All of the entities that fall within the scope of group supervision should be included within the scope of the group ORSA. This should include insurance, reinsurance and non-(re)insurance undertakings, and both regulated and non-regulated entities, situated in the EEA and outside the EEA.

- 2.66. The group ORSA adequately captures all specificities of the group, including at least:

- a) risks specific to the group for example stemming from non-regulated entities, interdependencies within the group and their impact on the group's risk profile;
- b) risks that might not be taken into account at individual level, but that have to be taken into consideration at group level for example contagion risks;
- c) any differences between undertakings of the group, such as business strategy, business planning period and risk profile;
- d) national specificities, their effects and how they are reflected at the group level.

2.67. The participating insurance or reinsurance undertaking or insurance holding company responsible for the group ORSA ensures all necessary information to carry out the group ORSA and that the results are reliable.

(Re)insurance undertakings

2.68. The reference to (re)insurance undertakings covers all entities taking-up insurance or reinsurance activities including captive (re)insurance undertakings.

Third-country entities

2.69. Although third-country undertakings are not required to produce a solo ORSA, they have to be included in the group ORSA if they fall within the scope of group supervision.

2.70. Groups need to take account of any restrictions or challenges to the assessment at group level that may arise from third-country undertakings. For example, this might include any impediments to accessing information and restrictions on the timeliness of information to be provided by the undertakings.

Regulated non-(re)insurance undertakings

2.71. The group ORSA assesses all material risks arising from regulated non-insurance or reinsurance entities within the group, since these entities contribute to the group solvency in proportion to the share held by the participating undertaking in accordance with Article 221.

Non-regulated entities

2.72. While non-regulated entities are not subject to solo supervision and are not expected to perform an ORSA at the individual level, they have to be included in the scope of group ORSA, if they fall within the scope of group supervision.

2.73. The nature of the assessment with respect to non-regulated entities will depend on the nature, size and complexity of each non-regulated entity and its role within the group. Some non-regulated entities may play a very important role in setting the strategy and hence in defining the risk profile at the group level that is implemented throughout the group. On the other hand, non-regulated entities, such as insurance holding companies, may be just instruments that are used for a particular for example to acquire holdings in subsidiaries as set out in Article 212(1)(f) of Solvency II and have no influence in setting the business strategy. The group ORSA will have to be sufficiently dynamic to capture the different nature of the material risks from all non-regulated entities within the scope of the group.

Guideline 16 – Reporting to the supervisory authorities
 The document sent to the group supervisor with the outcome of the group ORSA should be in the same language as the group regular supervisory reporting.
 If a single ORSA has been approved and, where any of the subsidiaries has its head office in a Member State whose official languages are different from the languages in which the single ORSA document is reported, the supervisory authority concerned may, after consulting the group supervisor, the college of supervisors and the group itself, require the undertaking to include a translation of the part of the ORSA information concerning the subsidiary into an official language of that Member State.

2.74. The following table summarises the reporting requirements linked to the group ORSA:

		Article 254(2), Article 35(2) (a)(i) and draft Article 294 SRS1	Article 254(2) and Article 35(2) (a)(ii)
Group ORSA (not including the assessment at individual level of the subsidiaries)	Participating undertaking	Group ORSA supervisory report reported to the group supervisor	Group ORSA supervisory report reported to the group supervisor whenever an ORSA is performed
	Subsidiary	Solo supervisory report includes cross references to the group ORSA (supervisory	Solo supervisory report includes cross references to the group ORSA

Individual ORSA (at subsidiaries' individual level)		report)	(supervisory report).
Single ORSA document covering all the assessments (article 246(4) 3rd subparagraph option)	Participating undertaking	Single supervisory report of ORSA submitted to all supervisory authorities concerned whenever a regular ORSA is performed	Single supervisory report of ORSA submitted to all supervisory authorities concerned whenever a non-regular ORSA is performed

2.75. It is not necessary that all individual undertakings within the group are in the scope of the single ORSA document. However, if the group applies for a single ORSA document all relevant members in the college given the scope of the application should be involved in the decision as set out in the guideline.

2.76. After a demand from the group to perform a single ORSA document, if there is no other decision process in force in the college and if any college member that would otherwise receive an individual ORSA document disagrees, the group supervisor could authorize the group to perform a single ORSA document excluding those undertakings above mentioned which should present its own individual ORSA to the respective national supervisor.

2.77. Specifically, the following two situations could arise:

- a) The participating undertaking does not apply for a single ORSA document. In this case, the participating insurance or reinsurance undertaking or the insurance holding company performs the ORSA at the level of the group and the individual undertaking performs its individual ORSA.
- b) The participating insurance or reinsurance undertaking or the insurance holding company opts for a single document for ORSA. In this case a single supervisory report has to be provided. Nevertheless, compliance with Article 45 of Solvency II needs to be ensured by the subsidiaries concerned. It is required that the document has to be submitted to all supervisory authorities

concerned. This applies to the regular report of the ORSA and to reports following predefined events.

2.78. The main findings regarding the ORSA will be discussed in the College of Supervisors.

Guideline 17 – Group specificities on overall solvency needs

The responsible entity should adequately assess the impact of all group specific risks and interdependencies within the group and the impact of these risks and interdependencies on the overall solvency needs. The responsible entity should take into consideration the specificities of the group and the fact that some risks may be scaled up at the level of the group.

In accordance with Guideline 5 on the record of each ORSA, the responsible entity should include in the record of the group ORSA at least a description on how the following factors were taken into consideration for the assessment of overall solvency needs:

- a) the identification of the possible sources of capital within the group and identification of potential needs for additional capital;
- b) the assessment of availability, transferability or fungibility of capital;
- c) references to any envisaged transfer of capital within the group, which would have a material impact on any entity of the group, and its consequences;
- d) alignment of individual strategies with the ones established at the level of the group;
- e) specific risks the group could be exposed to.

2.79. The group ORSA identifies the impact on the group solvency and related undertakings arising from all material risks that the group is facing. In addition to the risks considered in the SCR calculation, all material risks including group specific risks, and particularly risks that are not quantifiable, have to be taken into consideration.

2.80. The group ORSA describes the interrelationships between the risks of the participating insurance or reinsurance undertaking or the insurance holding company and of the individual undertakings.

2.81. The group ORSA also assesses the materiality of risks that arise at the level of the group and are specific for groups and thus cannot be identified at the individual level. Hence, those group specific risks are not taken into account in the consolidation or aggregation process depending on the calculation method used.

2.82. The group specific risks include for example:

- a) contagion risk, for example spill-over effect of risks that have manifested in other parts of the group;
- b) risks arising from intra-group transactions and risk concentration, notably in relation to:
 - (i) participations;
 - (ii) intra-group reinsurance or internal reinsurance;
 - (iii) intra-group loans;
 - (iv) intra-group outsourcing;
- c) operational risks arising from the complexity of the group structure; and
- d) risks arising from the complexity of the group structure.

2.83. In addition to the information required in [1.23 Guideline 7] at the group level, the group ORSA document includes:

- a) a description of the materiality of each related entity at the group level, particularly the contribution of each related entity to the overall group risk profile;
- b) the outcome of the comparison between the group overall solvency needs and the sum of the solo overall solvency needs; and
- c) the assessment of any diversification effects assumed at the group level.

2.84. A group specific component of the group ORSA is the analysis of diversification effects assumed at group level. This includes the analysis of the reasonableness of the diversification effects assumed at the group level compared to the risk profile of the group and the overall solvency needs of the group.

Guideline 18 - Group specificities on the continuous compliance with regulatory capital requirements

In accordance with Guideline 5 on the record of each ORSA, the responsible entity should include in the record of the group ORSA at least a description on how the following factors were taken into consideration for the assessment of continuous compliance with regulatory requirements:

- a) the identification of the sources of own funds within the group and if there is a need for additional own funds;
- b) the assessment of availability, transferability or fungibility of own funds;
- c) references to any planned transfer of own funds within the group, which would have a material impact on any entity of the group, and its

- consequences;
- d) alignment of individual strategies with the ones established at the level of the group;
- e) specific risks the group could be exposed to.

2.85. From a quantitative perspective, it is expected that the group ORSA policy outlines different stress tests and scenario analyses.

Guideline 19 – Specific requirements for a single ORSA document

When applying to submit a single ORSA document, the responsible entity should provide an explanation of how the subsidiaries are covered and how the AMSBs of the subsidiaries are involved in the assessment process and approval of the outcome.

2.86. The single ORSA document needs to reflect the nature, scale and complexity of the group and the risks within it. The single document focuses on the material parts of the group, but according to Article 246(4) of Solvency II it does not exempt subsidiaries from the obligations relating to the ORSA at individual level. This means that the single document for ORSA also has to document the assessments undertaken by insurance and reinsurance subsidiary undertakings at the individual level according to Article 45 of Solvency II.

2.87. If a group plans to submit a single group report for the ORSA, the AMSB of the entity responsible for fulfilling the group requirements needs to take into consideration the following criteria when assessing the appropriateness of submitting a single group document:

- a) the results of each subsidiary concerned are individually identifiable in the structure foreseen for the single document for ORSA to enable a proper supervisory review process to be carried out at the individual level by the individual supervisors concerned;
- b) the single report of the ORSA satisfies the requirements of both the group supervisor as well as the individual supervisors concerned.

Guideline 21 – Integration of related third-country insurance and re-insurance undertakings

In the assessment of the group overall solvency needs, the responsible entity should include the risks of the business in third countries in a consistent manner as it does for European Economic Area-business with special attention to the assessment of transferability and fungibility of capital.

2.88. The business of these third-country undertakings is assessed taking into account the following:

- a) Both where the solvency regime of a third country has been deemed to be equivalent to the one set by Solvency II and where it has not, the group should carry out the assessment of the overall solvency needs set out in Article 45(1)(a) in the same manner as for EEA undertakings. The integration of the risks of third-country undertakings with the risks of EEA undertakings in the group should guarantee that similar risks are homogeneously assessed from an economic point of view;
- b) Both where the solvency regime of a third country has been deemed to be equivalent to in the one set by Solvency II and where it has not, the group needs to assess particularly the transferability and fungibility of the third-country undertaking own funds. The assessment explicitly identifies the regulation of the third country that may hinder or impede the full fungibility and transferability of the own funds of the subsidiaries of such third country towards any other undertaking of the group;
- c) If a third-country entity is included in the group solvency assessment using local rules and the deduction and aggregation method (in case of equivalence), the assessment of the significance with which the risk profile of the subsidiary of that third country deviates from the assumptions underlying the solvency capital requirement, as set out in Article 45(1)(c) of Solvency II, shall refer to the capital requirements as laid down in the regulations of that third country. This assessment has to be carried out both at a holistic level and at a more granular level, for which the group assesses the specific deviations of each material element of the calculation of the capital requirement.

2.89. The group ORSA includes a separate and adequate disclosure of any material information concerning third-country undertakings.