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Explanatory Text
On the Proposal for Guidelines on
the System of Governance

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Introduction

- 1.1. The boxes included in this document reproduce the Guidelines that have been published by EIOPA in the Consultation Paper EIOPA-CP-13/08.
- 1.2. This document only aims to facilitate the reading of the Consultation Paper EIOPA-CP-13/08 and is not subject to public consultation.

Guidelines

Section I: General Provisions for preparatory Guidelines

Guideline 1- General provisions for Guidelines

National competent authorities should take the appropriate steps in order to put in place from 1 January 2014 the present Guidelines on System of Governance.

National competent authorities should ensure that insurance and reinsurance undertakings and groups take the appropriate steps to:

- a. build an effective system of governance according to the Solvency II Directive which provides for sound and prudent management;**
- b. build an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies; and**
- c. build qualitative information supporting the system of governance that will allow national competent authorities to review and evaluate the quality of the information.**

Guideline 2 - Progress report to EIOPA

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

Section II: System of Governance

Chapter I: General governance requirements

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

In accordance with Article 41 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the undertaking has appropriate interaction with any committee it establishes as well as with senior management and with other key functions in the undertaking, requesting information from them proactively and challenging that information when

necessary.

In accordance with Article 246 of Solvency II, national competent authorities should ensure that at group level, the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements has an appropriate interaction with the administrative, management or supervisory bodies of all entities within the group, requesting information proactively in the matters that may affect the group and challenging the decision making both at group and entity level.

- 1.1. The focal point of the governance system is the administrative, management or supervisory body. 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.
- 1.2. 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 etc.

Guideline 4 – Organisational and operational structure

In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking has organisational and operational structures aimed at supporting the strategic objectives and operations of the undertaking. Such structures should be able to be adapted to changes in the strategic objectives, operations or in the business environment of the undertaking within an appropriate period of time.

In accordance with Article 246 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements at group level assesses how changes to the group’s structure impact on the soundness of the undertaking and makes the necessary adjustments in a timely manner.

In accordance with Article 246 of Solvency II, national competent authorities should ensure that, in order to take appropriate measures, the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements at group level knows the corporate organisation of the group, the purpose of its different entities and the links and relationships between them as well as keep itself informed about the risks arising from the group’s

structure.

- 1.3. 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.
- 1.4. 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.
- 1.5. 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.
- 1.6. 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.
- 1.7. 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.
- 1.8. 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.

- 1.9. 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.
- 1.10. In principle, incompatible functions, i.e. tasks that if performed by the same persons could give rise to conflicts of interest, 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. Where a complete separation of these functions would be disproportionate, the undertaking has to manage them appropriately to safeguard proper decision-making or execution of tasks. In large undertakings and in undertakings with more complex risk profiles it is expected that the key functions are performed by separate units .
- 1.11. Apart from the internal audit function, which has to be fully independent from all other functions, all other key functions explicitly mentioned in Solvency II 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.
- 1.12. The internal audit function, by contrast, and according to Article 47(3) of Solvency II, has to be objective and independent from the operational functions. In practice, this means that there needs to be a separate unit or an individual without other duties within the undertaking unless the function is outsourced.
- 1.13. 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 Solvency II 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.

- 1.14. The segregation of key functions does not automatically provide for operational independence and other measures may also be necessary.
- 1.15. Operational independence implies that the key functions are able to report their results and any concerns they may have and suggestions for addressing these 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.
- 1.16. 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.
- 1.17. 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.
- 1.18. At group level the role and responsibilities of each undertaking in the group in respect of the group's overall strategic objectives and operations have also to be clearly defined in the group's policies.
- 1.19. 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 [(see interplay with group level in Title II)]. 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.
- 1.20. In order to ensure an effective system for providing the transmission of information in accordance with Article 41 (1) of Solvency II, second subparagraph, undertakings are required to introduce clear reporting lines that provide for the prompt transfer of information to all persons who need it. The information system has to set out which information is to be shared, by whom, and when. It needs to allow for information to flow between the undertaking's different levels of hierarchy as well as horizontally between different business units.
- 1.21. Apart from the active sharing of information, information systems are expected to produce sufficient, reliable, consistent, timely and relevant

information concerning all business activities, including the commitments assumed and the risks to which the undertaking is exposed. The undertaking decides who needs to have access to these information systems for the purpose of providing input from and information to their areas of responsibility. The undertaking also decides who the relevant personnel are that need to have passive access to the system so as to retrieve data for the proper discharge of their duties.

Guideline 5: Key functions

In accordance with Articles 44, 46, 47 and 48 of Solvency II, national competent authorities should ensure that the undertaking appropriately implements the following key functions: risk management function, compliance function, internal audit function and actuarial function.

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

Guideline 6 – Decision-making

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

1.22. 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 7 - Documentation of decisions taken at the level of the AMSB

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

Guideline 8 - Internal review of the system of governance

In accordance with Article 41 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the undertaking determines the scope and frequency of the internal reviews of the system of governance, taking into account the nature, scale and complexity of the business both at individual and at group level, as well as the structure of the group.

In accordance with Article 41 of Solvency II, national competent authorities should ensure that it is up to the undertaking to decide who is to perform the reviews within the undertaking.

In accordance with Article 41 of Solvency II, national competent authorities should ensure that the scope, findings and conclusions of the review are properly documented and reported to the administrative, management or supervisory body of the undertaking. Suitable feedback loops are necessary to ensure follow-up actions are undertaken and recorded.

1.23. 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.

1.24. 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 9 – Policies

In accordance with Article 41 of Solvency II, national competent authorities should ensure that the undertaking aligns all policies required as part of the system of governance with each other and with its business strategy. The policies should clearly set out at least:

- a. the goals pursued by the policy;**
- b. the tasks to be performed and the person or role responsible for**

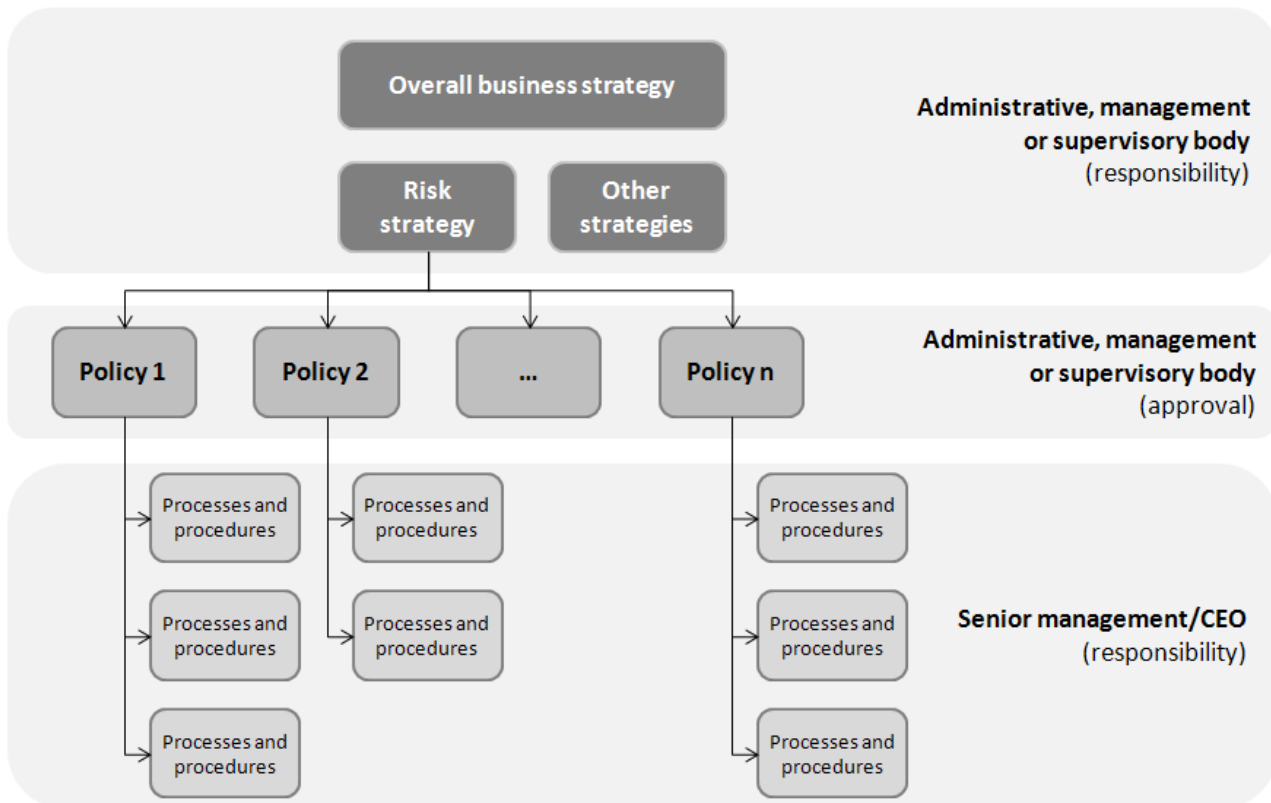
them;

c. the processes and reporting procedures to be applied; and

d. the obligation of the relevant organisational units to inform the risk management, internal audit and the compliance and actuarial functions of any facts relevant for the performance of their duties.

In accordance with Article 41 of Solvency II, national competent authorities should ensure that in the policies that cover the key functions, the undertaking also addresses the position of these functions within the undertaking, their rights and powers.

1.25. The AMSB is responsible for the development and setting of the business strategy. It also has to approve written policies in order to materialise that strategy. This idea is summarised as an example in the following chart:



1.26. The undertaking may combine the written policies required by Solvency II as it sees fit in line with its organisational structure and processes.

1.27. 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.

1.28. A proper implementation of the written policies requires ensuring that all 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.

- 1.29. 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) and the model change policy.
- 1.30. 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 10 - Contingency plans

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

- 1.31. 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.
- 1.32. 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.
- 1.33. The undertaking also has to give proper consideration to determining communication channels in case of emergencies.

Chapter II: Fit and Proper

- 1.34. 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.

Guideline 11 – Fit requirements

In accordance with Article 42 of Solvency II, national competent authorities should ensure that persons who effectively run the undertaking or have other key functions, including members of the administrative, supervisory or management body of the undertaking are 'fit' and take account of the respective duties allocated to individual members to ensure appropriate diversity of qualifications, knowledge and relevant experience to ensure that the undertaking is managed and overseen in a professional manner.

In accordance with Article 42 of Solvency II, national competent authorities should ensure that the undertaking ensures that the members of the administrative, management or supervisory body collectively possess at least qualification, experience and knowledge about:

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

- 1.35. 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.
- 1.36. 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.
- 1.37. 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.
- 1.38. 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.

- 1.39. '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.
- 1.40. 'Business strategy and business model knowledge' refers to a detailed understanding of the undertaking's business strategy and model.
- 1.41. '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.
- 1.42. '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.
- 1.43. '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

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

- 1.44. 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.

- 1.45. 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.
- 1.46. 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.
- 1.47. 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.
- 1.48. 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.
- 1.49. 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.
- 1.50. All persons are expected to avoid, to the extent possible, activities that could create conflicts of interest or the appearance of conflicts of interest.
- 1.51. 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.

- 1.52. 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

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

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

- 1.53. 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

In accordance with Article 42 and 49 of Solvency II, national

competent authorities should ensure that the undertaking applies the fit and proper requirements to the persons employed by the service provider or sub service provider to perform an outsourced key function.

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

1.54. 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.

1.55. 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.

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

Chapter II: Risk Management

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

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

In accordance with Article 246 of Solvency II, national competent authorities should ensure that the administrative, management or supervisory body of the entity responsible for fulfilling the governance requirements at group level is responsible for the effectiveness of the risk management system of the whole group. This risk management system should include at least:

- a. the strategic decisions and policies on risk management at**

group level;

- b. the definition of group's risk appetite and overall risk tolerance limits; and**
- c. the identification, measurement, management and control of risks at group level.**

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

1.57. While risk management is the responsibility of the undertaking's administrative management or supervisory body as a whole, the undertaking is expected to designate at least one member of the administrative, management or supervisory body to oversee the risk management system on its behalf.

1.58. 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.

1.59. Within an undertaking there has to be a coordinated and integrated approach to risk management and a common "risk language" across the organisation.

1.60. It is the responsibility of the undertaking to choose the way it defines and describe 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).

1.61. The definition of overall risk tolerance limits is understood and endorsed by the AMSB.

1.62. 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.

1.63. The AMSB is also responsible for the approval of any periodic revision of the main strategies and business policies of the undertaking in terms of risk management.

1.64. 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.

1.65. The interplay between individual and group levels is addressed in [Title II]. 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 administrative, management or supervisory bodies 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 administrative, management or supervisory body of the entity responsible for fulfilling the requirements at group level.

1.66. The identification and measurement or assessment of risks is to be documented.

- 1.67. 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.
- 1.68. In accordance with Article 44 of Solvency II, the undertaking identifies, assesses and monitors the following situations:
- a) actual or potential exposure to material reputational and strategic risks and the interconnectedness between these risks and other material risks; and
 - b) key issues affecting its reputation, considering the expectations of stakeholders and the sensitivity of the market.
- 1.69. 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.
- 1.70. 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.
- 1.71. 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.
- 1.72. 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 16 - Risk management policy

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

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

1.73. The risk management policy covers all material risks, including emerging risks¹, quantifiable or non-quantifiable and reputational and strategic risks where relevant.

1.74. 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).

1.75. 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.

1.76. 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.

¹Emerging risks are newly developing or changing risks which are difficult to quantify and which may have a major impact on the undertaking.

- 1.77. 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.
- 1.78. 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.
- 1.79. Although each individual undertaking within a group is responsible for its risk management policy, a general steer is expected to be provided by the entity responsible for the fulfilment of the governance requirements at group level [(see Title II)]. 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.
- 1.80. In accordance with Article 44 of Solvency II, credit assessments of external credit assessment institutions do not prevail in internal risk management methodologies of the undertaking. In particular, internal methodologies do not rely solely or mechanistically on external credit assessments. The undertaking takes steps to verify the appropriateness of external credit assessments as part of their risk management.
- 1.81. The undertaking has processes and procedures in place to identify changes in individual credit risks and credit portfolio risk and be capable of evaluating relevant parameters also where exposures are unrated.
- 1.82. Credit quality has to be assessed using objective techniques according to generally accepted practices.
- 1.83. Exposure to speculative grade assets has to be prudent and an undertaking facing larger credit risk exposures has to be capable of hedging credit risk.
- 1.84. The undertaking has to be aware that intra-group exposures give rise to credit risk just like any other external exposure does. The undertaking has to be able to demonstrate that it adequately considers credit risk for all its

counterparties and is not overly reliant on any counterparty, regardless of whether it lies within the same group.

1.85. The undertaking ensures that the credit risk exposure is sufficiently diversified. It has a process of credit risk management to ensure that exposure to any counterparty is managed and monitored with appropriate limits put in place.

1.86. The process of risk management is capable of mitigating any credit risk in relation to internally defined limits.

Guideline 17 - Risk management function: general tasks

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

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

Guideline 18 - Underwriting and reserving risk

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

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

1.87. 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.

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

1.89. 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 19 – Operational risk

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

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

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

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

- a. the failure of a key process, personnel or system; and**

b. the occurrence of external events.

- 1.90. 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.
- 1.91. 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.
- 1.92. 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.
- 1.93. 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.
- 1.94. 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.
- 1.95. 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.

- 1.96. 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.
- 1.97. The continuous monitoring and control of operational risks implies that all personnel are aware of the importance of this type of risk.
- 1.98. 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.
- 1.99. 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.
- 1.100. The undertaking is also expected to put in place key risk indicators.
- 1.101. 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.
- 1.102. 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.
- 1.103. 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 20 – Control and documentation of risk-mitigation

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

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

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

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

1.104. 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.

1.105. 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).

Guideline 22 - Asset-liability management

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

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

1.106. 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.

1.107. 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.

1.108. 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.

1.109. 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.

1.110. 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 23 - Investment risk

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

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

1.111. 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.

1.112. 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.

1.113. 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.

1.114. 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 24 - Liquidity risk

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

- a. the procedure for determining the level of mismatch between the cash inflows and the cash outflows of both assets and liabilities, including expected cash flows of direct insurance and reinsurance such as claims, lapses or surrenders;**
- b. consideration of total liquidity needs in the short and medium term including an appropriate liquidity buffer to guard against a liquidity shortfall;**
- c. consideration of the level and monitoring of liquid assets, including a quantification of potential costs or financial losses arising from an enforced realisation;**
- d. consideration of the identification and cost of alternative financing tools; and**
- e. consideration of the effect on the liquidity situation of expected new business.**

1.115. 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.

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

1.117.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.

1.118.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.

Chapter III: The “prudent person” principle and the system of governance

Guideline 25 - Investment risk management

In accordance with Article 132 of Solvency II, national competent authorities should ensure that for the purpose of the investment risk management the undertaking develops its own set of key risk indicators adapted to its risk management policy and business strategy.

In accordance with Article 132 of Solvency II, national competent authorities should ensure that the undertaking does not solely depend on the information provided by financial institutions, asset managers and rating agencies. In making its investment decisions, the undertaking should take into account the risks associated with the investments without relying only on the risk being adequately captured by the capital requirements.

1.119.The Guideline basically refers to the underlying prudent person principle for managing investments. This principle 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 must have an adequate understanding of the risks associated with its investments, its 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.
- c) 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.
- d) 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.

- e) 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.

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

- a) the implementation of the investment risk section of the risk management policy 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.

1.121. 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.

1.122. 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 26 – Assessment of non-routine investment activities

In accordance with Article 132 of Solvency II, national competent authorities should ensure that before performing any investment or investment activity of a non-routine nature the undertaking carries out an assessment of at least:

- a. its ability to perform and manage the investment or the investment activity;**
- b. the risks specifically related to the investment or the investment activity and the impact of the investment or the investment activity on the undertaking's risk profile;**
- c. the consistency of the investment or investment activity with the beneficiaries and policyholder's interest, liability constraints set by the undertaking and efficient portfolio management; and**
- d. the impact of this investment or investment activity on the quality, security, liquidity, profitability and availability of the whole portfolio.**

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

1.123.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.

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

1.125. 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.

1.126. 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 forward looking assessment of the undertaking's own risk (based on the ORSA principles).

Guideline 27 - Unit-linked and index-linked contracts

In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the investments of unit-linked and index-linked contracts of the undertaking are selected in the best interest of policyholders and beneficiaries taking into account

any disclosed policy objectives.

In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that, in the case of unit-linked business, the undertaking takes into account and manage the constraints related to unit-linked contracts, in particular liquidity constraints.

1.127. 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).

1.128. 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.

1.129. 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.

1.130. 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 28 - Assets not admitted for trading on a regulated financial market

In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking implements, manages, monitors and controls procedures in relation to investments that are not admitted to trading on a regulated financial market or to complex products, which are difficult to value.

In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking treats assets admitted to trading, but not traded or traded on a non-regular

basis, similarly to those assets not admitted to trading on a regulated financial market.

1.131. Where mark-to-model valuation is applied, the risk management function is responsible for model sign-off and review, independent price verification and stress-testing, as well as for internal control processes. 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.

1.132. 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 29 - Derivatives

In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking, when it uses derivatives, implements the procedures in line with its risk management policy on investments to monitor the performance of these derivatives.

In accordance with Articles 44 and 132 of Solvency II, national competent authorities should ensure that the undertaking demonstrates how the quality, security, liquidity or profitability of the whole portfolio is improved without significant impairment of any of these features where derivatives are used to facilitate efficient portfolio management.

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

1.133. With respect to assets other than those covered by Article 132 paragraph 3 of Solvency II, derivatives are only allowed for the purposes of efficient portfolio management or the reduction of risks.

1.134. 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.

1.135. 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.

1.136. 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.

1.137. 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.

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

Guideline 30 - Securitised instruments

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

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

1.140. 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.

1.141. 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.

Chapter IV: Own fund requirements and the system of governance

Guideline 31 – Capital Management Policy

In accordance with Article 41 and 93 of Solvency II, national competent authorities should ensure that the undertaking should be developing a capital management policy which includes:

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

Guideline 32 – Medium-term Capital Management Plan

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

- a. any planned capital issuance;**
- b. the maturity, incorporating both the contractual maturity and any earlier opportunity to repay or redeem, relating to the undertaking's own fund items;**
- c. how any issuance, redemption or repayment of, or other variation in the valuation of, an own funds item affects the application of any limits in the applicable capital regime; and**
- d. the application of the distributions policy.**

In accordance with Article 41 and 93 of Solvency II, national competent authorities should ensure that the undertaking takes into account in the capital management plan the output from the risk management systems and the forward looking assessment of the

undertaking's own risks (based on the ORSA principles).

Chapter V: Internal Controls

Guideline 33 – Internal Control environment

In accordance with Article 46 of Solvency II, national competent authorities should ensure that the undertaking promotes the importance of performing appropriate internal controls by ensuring that all personnel are aware of their role in the internal control system. The control activities should be commensurate to the risks arising from the activities and processes to be controlled.

In accordance to Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level ensures a consistent implementation of the internal control systems across the group.

1.142. Internal control combines the following aspects:

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

1.143. 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.

Guideline 34 – Monitoring and reporting

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

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

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

1.146. 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.

1.147. Monitoring mechanisms include procedures to detect deficiencies.

1.148. 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.

Chapter VI: Internal audit function

Guideline 35 – Independence

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

1.149. 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.

1.150. 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 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.

Guideline 36 - Internal audit policy

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

a. the terms and conditions according to which the internal audit

function can be called upon to give its opinion or assistance or to carry out other special tasks;

- b. internal rules setting out the procedures the person responsible for the internal audit function needs to follow before informing the supervisory authority; and**
- c. the criteria for the rotation of staff assignments.**

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

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

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

Guideline 37 – Internal audit plan

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

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

In accordance with Article 47 of Solvency II, national competent authorities should ensure that where necessary, the internal audit function may carry out audits which are not included in the audit plan.

1.152. 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.

1.153. 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 reviewed within a reasonable period of time, meaning according to the audit cycle principle.

Guideline 38 - Internal audit findings and recommendations

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

1.154. A written report of each assignment is issued as quickly as possible.

1.155. It is transmitted to the auditee and the auditee's hierarchy and - possibly as an executive summary - to the AMSB.

1.156. The internal audit function indicates the relative importance of the deficiencies found or recommendations made.

1.157. 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.

1.158. The internal audit function develops appropriate procedures to verify the manner how the recommendations are implemented.

Guideline 39 - Internal audit report for the administrative, management or supervisory body

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

1.159. 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.

Chapter VI: Actuarial Function

Guideline 40 - Tasks of the actuarial function

In accordance with Article 48 of Solvency II, national competent authorities should ensure that the undertaking takes appropriate measures to address the potential conflicts of interests, if the undertaking decides to add additional tasks or activities to the tasks and activities of the actuarial function.

In accordance to Article 246 of Solvency II, the national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level requires that the actuarial function gives in addition an opinion on the reinsurance policy and the reinsurance program for the group as a whole.

- 1.160. 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.
- 1.161. The undertaking needs to ensure and demonstrate that the processes of calculation and of validation of the technical provisions are independently performed.
- 1.162. 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 41 - Coordination of the calculation of technical provisions

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

1.163. 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.

1.164. In order to carry out this task, the actuarial function uses methodologies that allow for a complete analysis regarding those requirements.

1.165. 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.

1.166. 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 42 – Valuation models of technical provisions

In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking provides that the key drivers of the undertaking's risks are reflected and appropriately addressed in the valuation models underlying the calculation of the technical provisions, as well as in the assumptions and methodologies applied.

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

1.167. The actuarial function needs to understand the different drivers of risk that affect the level of technical provisions, the structure of dependencies and must be able to explain and document why the models used are

satisfactory. This explanation could be supported by techniques including any relevant analysis of internal data and market information, as well as back-testing and sensitivity tests. These techniques are particularly important in the assessment whether the technical provisions have been calculated in compliance with Articles 76 to 86 of Solvency II.

Guideline 43 – Data quality

In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking assesses the consistency of the internal and external data used in the calculation of technical provisions against the data quality standards as set in Solvency II and that the actuarial function provides recommendations, where relevant, on internal procedures to improve data quality so as to ensure that the undertaking is a position to comply with the related Solvency II requirement when implemented.

In accordance with Article 48 of Solvency II, national competent authorities should ensure that, if there are any differences amongst the technical provisions for different valuation dates, the undertaking ensures that the actuarial function presents an explanation for the deviations.

- 1.168. 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.
- 1.169. 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.
- 1.170. 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.
- 1.171. 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 44 – Testing against experience

In accordance with Article 48 of Solvency II, national competent authorities should ensure that the actuarial function of the undertaking reports any material deviations of actual experience

compared to the projected best estimate to the administrative, management or supervisory body. The report should identify the causes of the deviations and, where applicable, proposes changes in the assumptions and modifications that may be applied to the valuation model in order to improve the best estimate calculation.

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

1.173. 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 45 – Underwriting policy and reinsurance arrangements

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

1.174. 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 Solvency II.

1.175. 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 administrative, management or supervisory body, 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.

1.176. The opinion on the overall underwriting policy may include 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.

1.177. 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 administrative, management or supervisory body in reviewing the undertaking's underwriting policies.

1.178. The opinion on the adequacy of the undertaking's reinsurance arrangements may include 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.

1.179. 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.

1.180. The actuarial function provides information to the administrative, management or supervisory body 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 46 – The actuarial function of an undertaking with an internal model under pre-application

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

1.181. 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.

1.182. 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.

1.183. 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.

- 1.184. 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.
- 1.185. 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.
- 1.186. 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.
- 1.187. 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.
- 1.188. 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.
- 1.189. 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 47 - Annual internal report to the administrative, management or supervisory body

In accordance with Article 48 of Solvency II, national competent

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

1.190. 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.

1.191. 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.

1.192. 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.

1.193. In addition the undertaking ensures that the actuarial function provides annually at least:

- a) a description of the methodologies applied to calculate the technical provisions and an explanation on why these methodologies were chosen;
- b) a statement of the material assumptions on which the calculations of the technical provisions are based and a description of the rationale of their selection as well as an indication of the sensitivity of the assumptions underlying the calculation of the technical provisions for each of the major risks;

- c) a description of the review of the data used for the calculation of the technical provisions including a description of any adjustments made to the data;
- d) an assessment of the appropriateness and the scope of the validation procedures;
- e) a comparison of the technical provisions with the technical provisions in the preceding actuarial function report with explanations of any material differences, including details of changes in assumptions, the result of both calculations and a reconciliation of the two sets of technical provisions;
- f) the results of the comparison of best estimates against experience with an explanation of any material deviations;
- g) an opinion on the overall underwriting policy;
- h) an opinion on the overall reinsurance policy; and
- i) a description of the contribution to the risk modelling underlying the calculation of the capital requirements.

1.194. The undertaking ensure that the actuarial function presents any relevant deficiencies identified together with recommendations as to how the deficiencies could be remedied to the administrative, management or supervisory body.

Chapter VII: Outsourcing

1.195. 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 EU as well as outside.

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

1.197. 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.

1.198. 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.

1.199. 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.

1.200. 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.

Guideline 48- Critical or important operational function

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

1.201. 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.

1.202.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.

1.203.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 49 - Underwriting

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

1.204.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 the [Insurance Intermediaries Directive² (IMD)]. 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.

1.205. 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.

1.206. 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 50 - Intra-group outsourcing

In accordance with Article 49 of Solvency II, national competent authorities should ensure that, if key functions are outsourced within the group, the entity responsible for fulfilling the governance requirements at group level documents which functions relate to which legal entity and ensures that the performance of the key functions at the level of the undertaking is not impaired by such arrangements.

1.207. 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.

1.208. 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.

1.209. A written agreement must always exist, 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 Official Journal L 009 , 15/01/2003 P. 0003

1.210. 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 51 - Outsourcing written policy

In accordance with Article 49 of Solvency II, national competent authorities should ensure that the undertaking that outsources or considers outsourcing covers in its policy the undertaking's processes and strategies for outsourcing from the inception to the end of the contract. This in particular includes:

- a. how a service provider of suitable quality is selected;**
- b. the details to be included in the written agreement with the service; and**
- c. business contingency plans, including exit strategies.**

1.211. On (a), 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.

1.212. On (b), 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.

1.213. 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.

1.214. On (c), 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.

1.215. 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.

1.216. 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.

1.217. 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.

Section III: Group governance specific requirements

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

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

1.218. 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 53 - Responsibilities for setting internal governance requirements

In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level sets adequate internal governance requirements across the group appropriate to the structure, business and risks of the group and of its related entities, and considers the appropriate structure and organization for risk management at group level, setting a clear allocation of responsibilities between all entities of the group.

In accordance with Article 246 of Solvency II, national competent authorities should ensure that the entity responsible for fulfilling the governance requirements at group level does not impair the responsibilities of the administrative, management or supervisory body of each entity in the group when setting up its own system of governance.

1.219. 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.

1.220. 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 54 – System of Governance at group level

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

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

1.221. 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.

1.222. 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.

1.223. 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.

1.224. In discharging its corporate governance responsibilities, the administrative, management or supervisory body 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 55 - Risks with significant impact at group level

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

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

1.225. 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 56 - Group risk management

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

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

1.226. This guideline needs to be read in conjunction with guideline 14 Role of the administrative, management or supervisory body in the risk management system.

1.227. 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.

Guideline 57 – Group internal model

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