

CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: System of Governance

(former Consultation Paper 33)

October 2009

Table of contents

- 1. Introduction 3
- 2. Extract from Level 1 text 4
- 3. Advice 10
 - 3.1. General Governance Requirements 10
 - 3.2. Fit and Proper Requirements 16
 - 3.3. Risk Management System 19
 - 3.4. Internal Control 46
 - 3.5. Internal Audit 50
 - 3.6. Actuarial Function 53
 - 3.7. Outsourcing 63
- 4. Annexes 72
 - Annex A: Main conclusions taken out from the QIS 4 OpRisk questionnaire 72
 - Annex B: Impact assessment – Actuarial function 73

1. Introduction

- 1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence.
- 1.2. This Paper aims at providing advice for Level 2 measures with regard to the System of Governance as requested in Article 50 of the Solvency II Level I text¹ ("Level 1 text"). It also includes material that could be considered for the future when developing Level 3 guidance. The requirements and other explanatory material laid down in this Advice apply both at solo and at a group level. The requirements should be applied at a group level with the appropriate adaptations. Specificities of application at a group level are not covered by this Advice but will be addressed in a forthcoming CEIOPS Paper and could be further developed by CEIOPS in future Level 3 guidance if considered to be necessary.
- 1.3. CEIOPS believes that the Level 1 text already comprises a considerably high level of detail concerning principles and requirements on the system of governance, especially compared to the Level 1 text and/or Level 2 implementing measures in other EU directives on financial services. The text covers the most important issues to be regulated to ensure appropriate governance standards within insurance and reinsurance undertakings.
- 1.4. In view of this, CEIOPS considers the scope for essential and extensive measures on Level 2 to be limited. Article 50 of the Level 1 text stipulates the minimum contents of the future Level 2 implementing measures. CEIOPS covers all the areas mentioned in the article, but the level of detail depends on how detailed the Level 1 text already is in its requirements. Appropriate consideration was also given to the existing governance requirements for credit institutions and investment firms as set out in the regimes laid down in the Capital Requirements Directive (CRD) and the Markets in Financial Instruments Directive (MiFID).
- 1.5. The Level 1 text places considerable importance on written policies in relation to crucial aspects of the system of governance, in particular to risk management, internal control, internal audit and outsourcing. CEIOPS also expects to elaborate on these policies via Level 3 guidance and only addresses the required content of the asset-liability management and investment policies as these are explicitly singled out for implementing measures by Article 50 of the Level 1 text.
- 1.6. CEIOPS' view is that details on how the principle of proportionality applies cannot be properly prescribed in a principles-based system and accordingly does not propose any specific Level 2 implementing measures with regard to proportionality. This Consultation Paper does however address the principle, where appropriate, in order to give some indication as to how proportionality might play out in practice.

¹See Latest version from 19 October 2009 available at <http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf>

- 1.7. CEIOPS has, in the last months, deeply discussed several options when drafting the current Paper. However, only the main policy options considered regarding the actuarial function are explicitly reflected in the Paper (see section 3.6), as the European Commission is conducting a formal impact assessment regarding this function.
- 1.8. In drafting its advice, CEIOPS has also taken into consideration the lessons learnt from the financial crisis. Although the financial crisis has primarily highlighted fundamental governance failures in the banking sector and not the insurance sector, it is necessary to take lessons out of the crisis and make sure that the future Solvency II regulation on governance deals appropriately with the issues raised, both in normal and stressed times. These aspects have been reflected in suggested Level 2 implementing measures or earmarked for further consideration under Level 3 guidance as appropriate.

2. Extract from Level 1 text

- 2.1. According to the guiding principles referred to in the Commission's letter, the main basis for the advice presented in this Advice is primarily found in Articles 38, 41, 42, 44 and 46 to 50 of the Level 1 text which state:

Article 38 - Supervision of outsourced functions and activities

1. Without prejudice to Article 49, Member States shall ensure that insurance and reinsurance undertakings which outsource a function or an insurance or reinsurance activity take the necessary steps to ensure that the following conditions are satisfied:

(a) the service provider must cooperate with the supervisory authorities of the insurance and reinsurance undertaking in connection with the outsourced function or activity;

(b) the insurance and reinsurance undertakings, their auditors and the supervisory authorities must have effective access to data related to the outsourced functions or activities;

(c) the supervisory authorities must have effective access to the business premises of the service provider and must be able to exercise those rights of access.

2. The Member State where the service provider is located shall permit the supervisory authorities of the insurance or reinsurance undertaking to carry out themselves, or through the intermediary of persons they appoint for that purpose, on-site inspections at the premises of the service provider. The supervisory authority of the insurance or reinsurance undertaking shall inform the appropriate authority of the Member State of the service provider prior to conducting the on-site inspection. In the case of a non-supervised entity the appropriate authority shall be the supervisory authority.

The supervisory authorities of the Member State of the insurance or reinsurance undertaking may delegate such on-site inspections to the supervisory authorities of the Member State where the service provider is located.

2.2. Article 41 - General governance requirements

1. Member States shall require all insurance and reinsurance undertakings to have in place an effective system of governance which provides for sound and prudent management of the business.

That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. It shall include compliance with the requirements laid down in Articles 42 to 49.

The system of governance shall be subject to regular internal review.

2. The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.

3. Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing. They shall ensure that those policies are implemented.

Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative, management or supervisory body and be adapted in view of any significant change in the system or area concerned.

4. Insurance and reinsurance undertakings shall take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. To that end, the undertaking shall employ appropriate and proportionate systems, resources and procedures.

5. The supervisory authorities shall have appropriate means, methods and powers for verifying the system of governance of the insurance and reinsurance undertakings and for evaluating emerging risks identified by those undertakings which may affect their financial soundness.

The Member States shall ensure that the supervisory authorities have the powers necessary to require that the system of governance be improved and strengthened to ensure compliance with the requirements set out in Articles 42 to 49.

2.3. Article 42 - Fit and proper requirements for persons who effectively run the undertaking or have other key functions

1. Insurance and reinsurance undertakings shall ensure that all persons who effectively run the undertaking or have other key functions at all times fulfil the following requirements:

(a) their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit); and

(b) they are of good repute and integrity (proper).

2. *Insurance and reinsurance undertakings shall notify the supervisory authority of any changes to the identity of the persons who effectively run the undertaking or are responsible for other key functions, along with all information needed to assess whether any new persons appointed to manage the undertaking are fit and proper.*

3. *Insurance and reinsurance undertakings shall notify their supervisory authority if any of the persons referred to in paragraphs 1 and 2 have been replaced because they no longer fulfil the requirements referred to in paragraph 1.*

2.4. Article 44 - Risk management

1. *Insurance and reinsurance undertakings shall have in place 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.*

That risk-management system shall be effective and well integrated into the organisational structure and in the decision-making processes of the insurance or reinsurance undertaking with proper consideration of the persons who effectively run the undertaking or have other key functions.

2. *The risk-management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement as set out in Article 101(4) as well as the risks which are not or not fully included in the calculation thereof. The risk-management system shall cover at least the following areas:*

- (a) underwriting and reserving;*
- (b) asset–liability management;*
- (c) investment, in particular derivatives and similar commitments;*
- (d) liquidity and concentration risk management;*
- (e) operational risk management;*
- (f) reinsurance and other risk-mitigation techniques.*

The written policy on risk management referred to in Article 41(3) shall comprise policies relating to points (a) to (f) of the second subparagraph of this paragraph.

3. *As regards investment risk, insurance and reinsurance undertakings shall demonstrate that they comply with Chapter VI, Section 6.*

4. *Insurance and reinsurance undertakings shall provide for a risk-management function which shall be structured in such a way as to facilitate the implementation of the risk-management system.*

5. For insurance and reinsurance undertakings using a partial or full internal model approved in accordance with Articles 112 and 113 the risk-management function shall cover the following additional tasks:

- (a) to design and implement the internal model;
- (b) to test and validate the internal model;
- (c) to document the internal model and any subsequent changes made to it;
- (d) to analyse the performance of the internal model and to produce summary reports thereof;
- (e) to inform the administrative, management or supervisory body about the performance of the internal model, suggesting areas needing improvement, and up-dating that body on the status of efforts to improve previously identified weaknesses.

2.5. Article 46 - Internal control

1. Insurance and reinsurance undertakings shall have in place an effective internal control system.

That system shall at least include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the undertaking and a compliance function.

2. The compliance function shall include advising the administrative, management or supervisory body on compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive. It shall also include an assessment of the possible impact of any changes in the legal environment on the operations of the undertaking concerned and the identification and assessment of compliance risk.

2.6. Article 47 - Internal audit

1. Insurance and reinsurance undertakings shall provide for an effective internal audit function.

The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance.

2. The internal audit function shall be objective and independent from the operational functions.

3. Any findings and recommendations of the internal audit shall be reported to the administrative, management or supervisory body which shall determine what actions are to be taken with respect to each of the internal audit findings and recommendations and shall ensure that those actions are carried out.

2.7. Article 48 - Actuarial function

1. *Insurance and reinsurance undertakings shall provide for an effective actuarial function to:*

- (a) coordinate the calculation of technical provisions;*
- (b) ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;*
- (c) assess the sufficiency and quality of the data used in the calculation of technical provisions;*
- (d) compare best estimates against experience;*
- (e) inform the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions;*
- (f) oversee the calculation of technical provisions in the cases set out in Article 82;*
- (g) express an opinion on the overall underwriting policy;*
- (h) express an opinion on the adequacy of reinsurance arrangements; and*
- (i) contribute to the effective implementation of the risk-management system referred to in Article 44, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5, and to the assessment referred to in Article 45.*

2. *The actuarial function shall be carried out by persons who have knowledge of actuarial and financial mathematics, commensurate with the nature, scale and complexity of the risks inherent in the business of the insurance or reinsurance undertaking, and who are able to demonstrate their relevant experience with applicable professional and other standards.*

2.8. Article 49 – Outsourcing

1. *Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.*

2. *Outsourcing of critical or important operational functions or activities shall not be undertaken in such a way as to lead to any of the following:*

- (a) materially impairing the quality of the system of governance of the undertaking concerned;*
- (b) unduly increasing the operational risk;*
- (c) impairing the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations;*
- (d) undermining continuous and satisfactory service to policy holders.*

3. *Insurance and reinsurance undertakings shall, in a timely manner, notify the supervisory authorities prior to the outsourcing of critical or important functions or activities as well as of any subsequent material developments with respect to those functions or activities.*

2.9. Article 50 - Implementing measures

1. *The Commission shall adopt implementing measures to further specify the following:*

(a) *the elements of the systems referred to in Articles 41, 44, 46 and 47, and in particular the areas to be covered by the asset-liability management and investment policy, as referred to in Article 44(2), of insurance and reinsurance undertakings;*

(b) *the functions referred to in Articles 44 and 46 to 48;*

(c) *the requirements set out in Article 42 and the functions subject thereto;*

(d) *the conditions under which outsourcing, in particular to service providers located in third countries, may be performed.*

2. *Where necessary to ensure appropriate convergence of the assessment referred to in point (a) of Article 45(1), the Commission may adopt implementing measures to further specify the elements of that assessment.*

2.10. Article 246 - Supervision of the system of governance

1. *The requirements set out in Title I, Chapter IV, Section 2 shall apply mutatis mutandis at the level of the group.*

Without prejudice to the first subparagraph, the risk management and internal control systems and reporting procedures shall be implemented consistently in all the undertakings included in the scope of group supervision pursuant to points (a) and (b) of Article 213(2) so that those systems and reporting procedures can be controlled at the level of the group.

3. Advice

3.1. General Governance Requirements

Explanatory text

3.1. Article 41(1) of the Level 1 text states:

Member States shall require all insurance and reinsurance undertakings to have in place an effective system of governance which provides for sound and prudent management of the business.

That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. It shall include compliance with the requirements laid down in Articles 42 to 49.

The system of governance shall be subject to regular internal review..

3.2. It is important that undertakings ensure an organisational culture that enables and supports the effective operation of the system of governance. This requires an appropriate “tone at the top” with the administrative, management or supervisory body and senior management providing appropriate organisational values and priorities.

3.3. Although it is possible to infer, from the Level 1 text (Chapter IV, Section 2), that the “four-eyes principle” (i.e., the principle that prior to implementing any significant decision concerning the undertaking at least two persons review any such decision) should be complied with by all (re)insurance undertakings, CEIOPS believes that, in line with the existing requirements for other financial sectors, Level 2 implementing measures in the context of the system of governance could usefully include some more specific requirements, i.e. reference should be made to the fact that at least two persons effectively run the undertaking (four eyes’ principle).

3.4. The administrative, management or supervisory body is the focal point of the governance system. According to Article 40 of the Level 1 text, it is ultimately accountable and responsible for the compliance of the undertaking with legal and administrative requirements pursuant to the Level 1 text. Delegating to committees consisting of members of the administrative, management or supervisory body does not in any way release the administrative, management or supervisory body from collectively discharging its duties and responsibilities. The administrative, management or supervisory body needs to ensure that it has regular and robust interaction with any board committee on the one hand, and with senior management and with key functions on the other hand, and to recognise that part of its duties include requesting information proactively and challenging this information when necessary.

3.5. The nature and structure of the administrative, management or supervisory body will vary with the national company law applicable in the jurisdiction in

which the (re)insurance undertaking is incorporated. While some Member States have a one-tier board system, others have a two-tier board system with two bodies usually called supervisory board and management board.

- 3.6. The term “administrative, management or supervisory body” covers the single board in a one-tier system and the management or the supervisory board of a two-tier board system. According to the Directive the responsibilities and duties for the different bodies should be seen having regard to different national laws. When transposing the Level 1 text, each Member State will consider its own system and attribute each responsibility and duty to the appropriate board.
- 3.7. The undertaking’s system of governance should:
- a) Establish, implement and maintain effective cooperation, internal reporting and communication of information at all relevant levels within the undertaking;
 - b) Be robust with a clear and well-defined organisational structure that has well-defined, clear, consistent and documented lines of responsibility across the organisation;
 - c) Ensure that the members of the administrative, management or supervisory body possess sufficient professional qualifications, knowledge and experience in the relevant areas of the business to give adequate assurance that they are collectively able to provide a sound and prudent management of the undertaking;
 - d) Ensure it employs personnel with the skills, knowledge and expertise necessary to discharge properly the responsibilities allocated to them;
 - e) Ensure all personnel are aware of the procedures for the proper discharge of their responsibilities;
 - f) Establish, implement and maintain decision-making procedures;
 - g) Ensure that any performance of multiple tasks by individuals does not and is not likely to prevent the persons concerned from discharging any particular function soundly, honestly and professionally;
 - h) Establish information systems that produce sufficient, reliable, consistent, timely and relevant information concerning all business activities, the commitments assumed and the risks to which the undertaking is exposed;
 - i) Maintain adequate and orderly records of its business and internal organisation;
 - j) Safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question;
 - k) Introduce clear reporting lines that ensure the prompt transfer of information to all persons who need it in a way that enables them to recognise its importance; and

- l) Establish and maintain adequate risk management, compliance, internal audit and actuarial functions, the characteristics of which are set out below.
- 3.8. 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 should be given to drawing up and implementing a code of conduct for all staff. Apart from the general code of conduct, the members of the staff should also be familiar with more detailed codes applicable to their own areas of expertise.
- 3.9. Undertakings should ensure that any potential source of conflicts of interest is identified and procedures are established so that those involved with the implementation of the strategies and policies understand where conflicts of interest could arise and how these should be addressed, e.g. by establishing additional controls.
- 3.10. The undertaking should ensure that each key function has an appropriate standing in terms of organisational structure. Considering the principle of proportionality, CEIOPS believes that in large undertakings and in undertakings with more complex risk profiles the key functions should generally be performed by separate units.
- 3.11. In the context of the system of governance, an adequate interaction between the key functions should be fostered and adequately defined by each undertaking, including the establishment of communication and reporting procedures. All key functions should have access rights to the relevant systems and staff members, including any records, necessary to allow them to carry out their responsibilities.
- 3.12. Undertakings should adopt an overall remuneration policy that is in line with its business strategy, risk profile and objectives. It should avoid potential incentives for unauthorised or unwanted risk taking. The remuneration policy should cover the undertaking as a whole and contain specific arrangements that take into account the respective roles of the administrative, management or supervisory body and persons who have key functions. Further details on the remuneration issues are addressed in CEIOPS' consultation paper on "Remuneration Issues"².
- 3.13. Undertakings have to ensure that the system of governance is internally reviewed on a regular basis. To this purpose they have to determine the appropriate frequency of the reviews taking into account the nature, scale and complexity of their business and assign responsibility for the review.
- 3.14. In order to allow an adequate revision of the system of governance appropriate reporting procedures encompassing at least all key functions should be established. The reports to be produced shall encompass an assessment of the effectiveness of the system of governance and should contain suggestions for improvements. They should be presented to the administrative, management or supervisory body at least annually, according to the principle of proportionality, and discussions on any challenge provided or improvements suggested should

² See CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Remuneration Issues, CEIOPS-DOC-51/09, <http://www.ceiops.eu/index.php?option=content&task=view&id=610&Itemid=18>

be documented as appropriate. Suitable feedback loops should exist to ensure follow-up actions are continuously undertaken and recorded.

- 3.15. In addition to the referred above reporting procedures, the personnel who are responsible for key functions should also have direct access to the administrative, management or supervisory body.
- 3.16. CEIOPS does not intend to require or set any requirements on the format, content or structure of the report(s) to be produced.
- 3.17. Article 41(2) of the Level 1 text states:

The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.

- 3.18. The proportionality requirement applies to every element of the system of governance. It is the responsibility of the administrative, management or supervisory body to ensure that the undertaking's organisational structure delivers a system of governance proportionate to the nature, scale and complexity of the risks it faces in its business activities.
- 3.19. Subject to national law requirements, an undertaking's administrative, management or supervisory body should 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 to address these important issues.
- 3.20. Regarding the fulfilment of the internal audit function it should be noted that this cannot be combined with other operational duties or functions. According to Article 47(3) of the Level 1 text, the internal audit function shall be objective and independent from the operational functions. In effect this means that in the view of the majority of CEIOPS' Members³, the internal audit function – in contrast to the other functions explicitly mentioned in the Level 1 text – needs to be a separate unit or an individual without other duties within the undertaking, unless the function is outsourced. As stated in its advice to the European Commission on the Principle of Proportionality⁴, CEIOPS holds that, in order for this requirement not to create an unreasonable burden for undertakings with low risk profiles, these undertakings would not have to provide a permanently operating function as part of their organisation, but could outsource to a qualified (and independent) party to execute the tasks of the function.
- 3.21. Article 41(3) of the Level 1 text states:

Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant,

³ One Supervisory Authority holds that while independence from operational functions would as a rule require that internal auditors are limited to performing internal auditing tasks only, considering the principle of proportionality it is possible that the internal audit function is exercised by two members of the administrative, management or supervisory body, as its tasks are considered to be managerial rather than operational, provided the undertaking ensures that neither audits their own specific areas of responsibility.

⁴ See CEIOPS' Advice to the European Commission on the Principle of Proportionality in the Solvency II Framework Directive proposal, CEIOPS-DOC-24/08, May 2008, http://www.ceiops.eu/media/docman/public_files/publications/submissionstotheec/AdviceProportionality.pdf.

outsourcing. They shall ensure that those policies are implemented.

Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative, management or supervisory body and be adapted in view of any significant change in the system or area concerned.

- 3.22. The policies on risk management, internal control, internal audit and, where relevant, outsourcing, shall clearly set out the relevant responsibilities, goals, processes and reporting procedures to be applied, all of which shall be in line with the undertaking's overall business strategy.
- 3.23. Proper implementation of the written policies requires ensuring that all staff members are familiar with the policies relevant for their area of activities.
- 3.24. CEIOPS interprets the requirement for prior approval by the administrative, management or supervisory body to apply to any changes with regard to the content of the policies.
- 3.25. As a rule an annual review would be considered sufficient, unless the system or area concerned undergo significant change.

- 3.26. Article 41(4) of the Level 1 text states:

Insurance and reinsurance undertakings shall take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. To that end, the undertaking shall employ appropriate and proportionate systems, resources and procedures..

- 3.27. Undertakings shall develop and document contingency plans to ensure the business disruption and/or possible losses are limited if there is an unforeseen interruption to their systems and procedures. These might for example arise from natural catastrophes such as floods or earthquakes, terrorist attacks, serious fires, a breakdown of the IT systems or a pandemic that affects a large number of employees. Undertakings shall regularly identify the risks for which contingency plans should be in place taking into account the areas where they consider themselves to be especially vulnerable.
- 3.28. The plans shall be regularly tested and updated, to ensure that they are and remain effective, and communicated to the relevant management and staff.

CEIOPS' advice

- 3.29. The undertaking's system of governance shall:
 - a) Establish, implement and maintain effective cooperation, internal reporting and communication of information at all relevant levels within the undertaking;
 - b) Be robust with a clear and well-defined organisational structure that has well-defined, clear, consistent and documented lines of responsibility across the organisation;

- c) Ensure that the members of the administrative, management or supervisory body possess sufficient professional qualifications, knowledge and experience in the relevant areas of the business to give adequate assurance that they collectively are able to provide a sound and prudent management of the undertaking;
 - d) Ensure it employs personnel with the skills, knowledge and expertise necessary to discharge properly the responsibilities allocated to them;
 - e) Ensure all personnel are aware of the procedures for the proper discharge of their responsibilities;
 - f) Establish, implement and maintain decision-making procedures;
 - g) Ensure that any performance of multiple tasks by individuals does not and is not likely to prevent the persons concerned from discharging any particular function soundly, honestly and professionally;
 - h) Establish information systems that produce sufficient, reliable, consistent, timely and relevant information concerning all business activities, the commitments assumed and the risks to which the undertaking is exposed;
 - i) Maintain adequate and orderly records of its business and internal organisation;
 - j) Safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question;
 - k) Introduce clear reporting lines that ensure the prompt transfer of information to all persons who need it in a way that enables them to recognise its importance; and
 - l) Establish and maintain adequate risk management, compliance, internal audit and actuarial functions.
- 3.30. Undertakings shall ensure that at least two persons effectively run the undertaking [the four eye's principle].
- 3.31. Undertakings shall ensure that any potential source of conflicts of interest is identified and procedures are established so that those involved with the implementation of the strategies and policies understand where conflicts of interest could arise and how these shall be addressed, e.g. by establishing additional controls.
- 3.32. The undertaking shall ensure that each key function has an appropriate standing in terms of organisational structure.
- 3.33. The personnel who are responsible for the key functions shall have direct access to the administrative, management or supervisory body.
- 3.34. The policies on risk management, internal control, internal audit and, where relevant, outsourcing, shall clearly set out the relevant responsibilities, goals, processes and reporting procedures to be applied, all of which shall be in line with the undertaking's overall business strategy.

- 3.35. The undertaking shall regularly identify the risks for which contingency plans shall be in place taking into account the areas where they consider themselves to be especially vulnerable.
- 3.36. The plans shall be regularly tested and updated to ensure that they are and remain effective, and communicated to the relevant management and staff.

3.2. Fit and Proper Requirements

Explanatory text

- 3.37. Article 42 of the Level 1 text states:

Insurance and reinsurance undertakings shall ensure that all persons who effectively run the undertaking or have other key functions at all times fulfil the following requirements:

(a) their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit); and

(b) they are of good repute and integrity (proper).

Insurance and reinsurance undertakings shall notify the supervisory authority of any changes to the identity of the persons who effectively run the undertaking or are responsible for other key functions, along with all information needed to assess whether any new persons appointed to manage the undertaking are fit and proper.

Insurance and reinsurance undertakings shall notify their supervisory authority if any of the persons referred to in paragraphs 1 and 2 have been replaced because they no longer fulfil the requirements referred to in paragraph 1.

- 3.38. The provisions of Article 42(1) apply to all persons who effectively run the undertaking. These are not limited to the members of the administrative, management or supervisory body, but could include other persons such as senior managers⁵.
- 3.39. The other “key functions” are those considered critical or important in the system of governance and include at least the risk management, the compliance, the internal audit and the actuarial functions. Other functions may be considered key functions according to the nature, scale and complexity of an undertaking’s business or the way it is organised.
- 3.40. Undertakings need to establish who the persons that effectively run the undertaking are and which functions they consider key for their business,

⁵ In general terms, senior management could include persons employed by the undertaking who are responsible for high level decision making and implementing the strategies devised and the policies approved by the administrative, management or supervisory body.

including those set out in the previous paragraph. When deciding on the persons falling under the provisions of Article 42, the nature, scale and complexity of the risks inherent in the business of the undertaking should be taken into account, as well as the function itself and the way the undertaking is organised.

- 3.41. Undertakings shall notify the supervisory authority which persons effectively run the undertaking and which, if any, other key function holders are identified for the undertaking.
- 3.42. In addition to the qualifications that enable them to discharge their duties in their specific areas of responsibility, the members of the administrative, management or supervisory body should, collectively, be able to provide for the sound and prudent management of the undertaking.
- 3.43. Regarding the propriety requirement, all persons subject to Article 42 should each be proper. The proportionality principle does not result in different standards in the case of the propriety requirement, since the repute and integrity of the persons who effectively run the undertaking or hold key functions should always be on the same adequate level irrespective of the nature, scale and complexity of the business or of the undertaking's risk profile.
- 3.44. In order to ensure that all persons subject to Article 42 are proper and have the professional qualifications, knowledge and experience necessary to competently discharge their responsibilities, the undertaking needs to have in place appropriate documented policies and processes for assessing fitness and propriety. CEIOPS expects to develop criteria for assessing such policies and processes on Level 3.
- 3.45. The Level 1 text requires undertakings to notify the supervisory authority whenever the identity of persons effectively running the undertaking or responsible for other key functions changes.
- 3.46. CEIOPS understands the scope of persons for whom information is to be submitted to enable the supervisory authority to assess their fitness and propriety to be the same as the scope of the notification requirement. This implies, as a minimum, sufficient information to enable the supervisory authority to assess the fitness and propriety of persons who effectively run the undertaking and are responsible for "other key functions" as defined in paragraph 3.39, and may in addition include information regarding the fitness and propriety of persons responsible for key functions other than those defined in paragraph 3.39, depending on the nature, scale and complexity of the business.
- 3.47. Although the detailed criteria for the assessment of the fitness and propriety should only be developed under Level 3 guidance, taking into account existing 3L3 work in this area, CEIOPS believes that the following general criteria should already be established at Level 2.
- 3.48. When assessing the fitness of a person the supervisory authority must include an assessment of his/her professional competence. The assessment of professional competence covers the assessment of the competence in terms of management ('management competence') and in the area of the business activities carried out by the (re)insurance undertaking ('technical competence').

- 3.49. Both the assessment of the management and the technical competences of the person at stake must be based on the person's previous experience, knowledge and professional qualifications and should demonstrate due skill, care, diligence, and compliance with the relevant standards of the area/sector he/she has worked in.
- 3.50. When assessing the propriety of a person the supervisory authority should at least assess his/her reputation. The assessment of the reputation requires the supervisory authority to check whether there are reasons to believe from past conduct that the person may not discharge his/her duties in line with applicable rules, regulations and guidelines. Such reasons may arise, for instance, from criminal antecedents, financial antecedents, supervisory experience with that person or past business conduct. This approach does not imply that all previous infringements will automatically result in a declined application, but rather that individual supervisory authorities will assess them on a case-by-case basis.
- 3.51. Undertakings are required to notify their supervisory authority after a person subject to Article 42 has been replaced because he/she no longer fulfils the fitness and propriety requirements. CEIOPS expects to harmonise the particulars of this notification process on Level 3.
- 3.52. The supervisory authority must be notified of the following:
- (i) identification of the persons effectively running the undertaking and which other key function holders are identified for the undertaking;
 - (ii) the identity of the persons for whom information is to be submitted to enable the supervisory authority to assess their fitness and propriety; and
 - (iii) information about the persons subject to Article 42 that have been replaced because they no longer fulfil the fitness and propriety requirements.
- 3.53. These notifications do not imply a pre-approval by the supervisory authorities.
- 3.54. CEIOPS believes that a notification process encompasses the notification by the undertaking in a timely manner of the persons referred to in the previous paragraphs and the possibility of the supervisory authority, in case any doubts arise, to question the undertaking regarding the appointment of that person. The notification should be accompanied by all the necessary information allowing the supervisory authority to conduct an assessment.
- 3.55. Ultimately, if the supervisory authority concludes, with adequate justification, that the person to be appointed/already appointed does not comply with the relevant fit and proper requirements the supervisory authority has the power to require the undertaking not to appoint, or to replace, the person in question. Any such decision will follow due process.

CEIOPS' advice

- 3.56. Undertakings shall have in place documented policies and procedures to ensure that all persons subject to Article 42 are fit and proper.
- 3.57. Key functions are those considered important or critical in the system of governance and include at least the risk management, the compliance, the internal audit and the actuarial functions. Other functions may be considered key functions according to the nature, scale and complexity of an undertaking's business or the way it is organised.
- 3.58. Undertakings shall notify the supervisory authority of the persons who effectively run the undertaking and which, if any, other key function holders are identified for the undertaking.
- 3.59. When assessing the fitness of a person the supervisory authority shall include an assessment of his/her professional competence. The assessment of professional competence covers the assessment of the competence in terms of management ('management competence') and in the area of the business activities carried out by the (re)insurance undertaking ('technical competence').
- 3.60. Both the assessment of the management and the technical competences of the person at stake shall be based on the person's previous experience, knowledge and professional qualifications and shall demonstrate due skill, care, diligence, and compliance with the relevant standards of the area/sector he/she has worked in.
- 3.61. In addition to the qualifications that enable them to discharge their duties in their specific areas of responsibility, the members of the administrative, management or supervisory body shall, collectively, be able to provide for the sound and prudent management of the undertaking.
- 3.62. When assessing the propriety of a person the supervisory authority shall at least assess his/her reputation. The assessment of the reputation requires the supervisory authority to check whether there are reasons to believe from past conduct that the person may not discharge its duties in line with applicable rules, regulations and guidelines. Such reasons may arise, for instance, from criminal antecedents, financial antecedents or supervisory experience with that person. Insofar as the person's past business conduct is known this could provide reasons to question the person's integrity.

3.3. Risk Management System

Explanatory text

- 3.63. Article 44(1) of the Level 1 text states:

Insurance and reinsurance undertakings shall have in place 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.

That risk-management system shall be effective and well integrated into the organisational structure and in the decision-making processes of the insurance or reinsurance undertaking with proper consideration of the persons who effectively run the undertaking or have other key functions.

- 3.64. Risk management is a continuous process that should be used in the implementation of the undertaking's overall strategy and should allow 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.
- 3.65. The administrative, management or supervisory body is responsible for ensuring that the implemented risk management system is suitable, effective and proportionate to the nature, scale and complexity of the risks inherent in the business.
- 3.66. The administrative, management or supervisory body 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.
- 3.67. CEIOPS understands "strategies" as high-level plans that are developed by the administrative, management or supervisory body and are further specified via policies and business plans to ensure implementation in day-to-day business. "Policies" are internal guidelines established by senior management in line with the relevant strategies to outline the framework that staff has to take into account when exercising their responsibilities.
- 3.68. The risk management system needs to be documented and communicated to relevant management and staff to ensure it is embedded within the business.
- 3.69. An effective risk management system covers all material risks and requires at least the following:
 - a) A clearly defined and well documented risk management strategy that includes the risk management objectives, key risk management principles, general risk appetite and assignment of responsibilities across all the activities of the undertaking and is consistent with the undertaking's overall business strategy;
 - b) Adequate written policies that include a definition and categorisation of the material risks faced by the undertaking, by type, and the levels of acceptable risk limits for each risk type, implement the undertaking's risk strategy, facilitate control mechanisms and take into account the nature, scope and time horizon of the business and the risks associated with it;
 - c) Appropriate processes and procedures which enable the undertaking to identify, assess, manage, monitor and report the risks it is or might be exposed to;

- d) Appropriate reporting procedures and feedback loops that ensure that information on the risk management system, which is coordinated and challenged by the risk management function is actively monitored and managed by all relevant staff and the administrative, management or supervisory body;
 - e) Reports that are submitted to the administrative, management or supervisory body by the risk management function on the material risks faced by the undertaking and on the effectiveness of the risk management system; and
 - f) An appropriate own risk and solvency assessment (ORSA) process⁶.
- 3.70. Article 112(5) of the Level 1 text states that the supervisory authority shall give approval for use of an internal model in calculating the SCR only if they are satisfied that the systems of the undertaking for identifying, measuring, monitoring, managing and reporting risk are adequate. Undertakings who are seeking to apply for internal model approval need therefore to ensure that their risk management system is effective to ensure the model can be approved.
- 3.71. The risk management system shall be integrated into the organisational structure of the undertaking and into its decision-making processes. Good integration includes, in particular, that the risk management system should be supported by a suitable internal control system. The design and operational effectiveness of the risk management system to identify, measure, monitor, manage and report risks the undertaking is exposed to shall be regularly evaluated and reported by the risk management function. The internal audit function will review the assessment process.

CEIOPS' advice

- 3.72. An effective risk management system requires at least the following:
- a) A clearly defined and well documented risk management strategy that includes the risk management objectives, key risk management principles, general risk appetite and assignment of risk management responsibilities across all the activities of the undertaking and is consistent with the undertaking's overall business strategy;
 - b) Adequate written policies that include a definition and categorisation of the material risks faced by the undertaking, by type, and the levels of acceptable risk limits for each risk type, implement the undertaking's risk strategy, facilitate control mechanisms and take into account the nature, scope and time horizon of the business and the risks associated with it;

⁶ See CEIOPS' Issues Paper on the Own Risk and Solvency Assessment, CEIOPS-IGSRR-09/08, May 2008, http://www.ceiops.eu/media/docman/public_files/consultations/IssuesPaperORSA.pdf.

- c) Appropriate processes and procedures which enable the undertaking to identify, assess, manage, monitor and report the risks it is or might be exposed to;
- d) Appropriate reporting procedures and feedback loops that ensure that information on the risk management system, which is coordinated and challenged by the risk management function is actively monitored and managed by all relevant staff and the administrative, management or supervisory body;
- e) Reports that are submitted to the administrative, management or supervisory body by the risk management function on the material risks faced by the undertaking and on the effectiveness of the risk management system; and
- f) A suitable own risk and solvency assessment (ORSA) process.

Areas to be covered by the risk management system

Explanatory text

3.73. Article 44(2) and (3) of the Level 1 text states:

2. The risk-management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement as set out in Article 101(4) as well as the risks which are not or not fully included in the calculation thereof.

The risk-management system shall cover at least the following areas:

- (a) underwriting and reserving;*
- (b) asset–liability management;*
- (c) investment, in particular derivatives and similar commitments;*
- (d) liquidity and concentration risk management;*
- (e) operational risk management;*
- (f) reinsurance and other risk-mitigation techniques.*

The written policy on risk management referred to in Article 41(3) shall comprise policies relating to points (a) to (f) of the second subparagraph of this paragraph.

3. As regards investment risk, insurance and reinsurance undertakings shall demonstrate that they comply with Chapter VI, Section 6.

3.74. Article 50(1) requires the Commission to adopt implementing measures specifying amongst others the risk management system and in particular the

areas to be covered by the asset-liability management and investment policies of undertakings, as referred to in Article 44(2). CEIOPS considers the Level 1 text to be quite clear with regard to the areas to be covered by risk management. Undertakings have to establish a risk management system that takes into account all relevant risks they might be exposed to whether they are covered by the areas explicitly referred to in Article 44(2) or not. CEIOPS does however propose that risks whose importance has been highlighted by the current financial crisis be taken into account on Level 2 in order to ensure that they receive due consideration by undertakings.

- 3.75. Concerning the written policies that need to be established in relation to points (a) to (e) of the second subparagraph of Article 44(2), this Paper only focuses on the asset-liability management and investment policies as these are of crucial importance for an effective risk management and are specifically singled out for implementing measures by Article 50 of the Level 1 text. CEIOPS intends to cover supervisory expectations on the contents of the other written policies in future Level 3 guidance on the system of governance.
- 3.76. The risk management system of the undertaking should cover not only the risks included in the SCR, as per Article 101(4) of the Level 1 text, but also all other risks that may be considered materially relevant in the context of the undertaking's business.
- 3.77. In this Paper CEIOPS does not follow the risk categorisation of the standard formula but rather addresses the areas to be covered at a minimum by the risk management system as prescribed by Article 44(2) first subparagraph.
- 3.78. Credit risk management is addressed additionally in the paper together with the potentially most relevant "other risks" an undertaking may be exposed to, e.g. strategic and reputational risk. CEIOPS expects to elaborate in its Level 3 guidance further on these and possibly on more "other risks" not mentioned in this Advice.

Risk areas specifically identified in Article 44(2)

- 3.79. The risk management system is required to include at least the following areas:

- Underwriting and reserving

Explanatory text

- 3.80. Underwriting risk refers to the risk of loss, or of adverse change in the value of insurance liabilities, due to inadequate pricing and reserving assumptions.
- 3.81. Underwriting and reserving risk includes the fluctuations in the timing, frequency and severity of insured events, relative to the expectations of the undertaking at the time of underwriting. This risk can also refer to fluctuations in the timing and amount of claims settlements.

- 3.82. A proper strategy for underwriting and reserving risk should include at least:
- a) The classes and characteristics of the insurance business (i.e. the type of insurance risk) the undertaking is willing to accept;
 - b) The undertaking's exposure to specific risk concentrations;
 - c) Internal underwriting limits;
 - d) The adequacy of premium income to cover expected claims and expenses;
 - e) Considerations regarding the investment policy;
 - f) Reinsurance and other risk mitigation strategies and their effectiveness; and
 - g) The identification of the risks arising from the undertaking's insurance obligations, including embedded options and guaranteed surrender values in the products, and the resulting capital requirements of its exposures.
- 3.83. Suitable processes and procedures should be in place to ensure the reliability, sufficiency and adequacy of both the statistical and accounting data to be considered both in the underwriting and reserving processes.
- 3.84. The undertaking should ensure that all policies and procedures established for underwriting are applied by all distribution channels of the undertaking insofar as they are relevant for them.
- 3.85. The processes to be established should include reliable methods for evaluation of the methods chosen, e.g. back-testing of the methods used against statistical data such as the run-off of claims provisions.
- 3.86. The undertaking should have in place adequate claims management procedures which should cover the overall cycle of claims: receipt, assessment, processing and settlement, complaints and dispute settlement and reinsurance recoverables.

CEIOPS' advice

- 3.87. Suitable processes and procedures shall be in place to ensure the reliability, sufficiency and adequacy of both the statistical and accounting data to be considered both in the underwriting and reserving processes.
- 3.88. The undertaking shall ensure that all policies and procedures established for underwriting are applied by all distribution channels of the undertaking insofar as they are relevant for them.
- 3.89. The undertaking shall have in place adequate claims management procedures which shall cover the overall cycle of claims: receipt, assessment, processing and settlement, complaints and dispute settlement and reinsurance recoverables.

- Asset-liability management

Explanatory text

- 3.90. 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.
- 3.91. Along with the investment strategy, an ALM strategy should describe 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.
- 3.92. The ALM strategy should usefully have regard to at least:
- a) The structure of the asset-liability approach, including the time horizon;
 - b) The portfolio of assets and liabilities, including obligations to pay bonuses to policyholders;
 - c) The stress tests to be performed to ascertain of adverse movements in the undertaking's investment portfolio and asset-liability positions;
 - d) A validation of parameters and hypotheses by comparison with earlier observations (back-testing); and
 - e) The interaction between the ALM strategy and policy and the investment strategy and policy.
- 3.93. When choosing from the different ALM techniques available for measuring risk exposure, an undertaking should rely on measurement tools that are consistent with the risk characteristics of the lines of business and its risk tolerance. The undertaking should also take into account its ALM objectives and the sophistication of its management information system.
- 3.94. In order to provide for the effective management of assets and liabilities, the undertaking should ensure appropriate and continuing liaison between the different areas within its business involved in the ALM.
- 3.95. The ALM framework should not only recognise the interdependence between assets and liabilities but also take into account any correlations of risks between different asset classes and any correlations between different products and business lines.
- 3.96. Undertakings should also have regard to any off-balance sheet exposures that they may have.
- 3.97. The undertaking should have effective procedures for monitoring and managing the asset-liability positions, including any off-balance sheet exposures, and to ensure that investment activities and asset positions are appropriate to the risk

profile of its liabilities.

- 3.98. When introducing new products, the undertaking should consider how these affect the management of assets and liabilities.

Policy on asset-liability management

- 3.99. The undertaking shall develop written ALM policies that especially take into account the interrelation with different types of risks, such as market risks, credit risks, liquidity risks and underwriting risks, and establish ways to manage the possible effect of options embedded in the insurance products.

3.100. Hence, the ALM policy shall provide for:

- a) A structuring of the assets that ensures the undertaking holds sufficient cash and diversified marketable securities of an appropriate nature, term and liquidity to meet its obligations, including obligations to pay bonuses to policyholders, as they fall due;
- b) A plan to deal with unexpected cash outflows, or changes in expected cash in- and outflows; and
- c) The identification of mitigation techniques and their impact on embedded options, and the assessment of the possible effects these can have throughout the life of the insurance policies and/or reinsurance contracts.

- 3.101. The undertaking shall tailor its ALM policies to the needs of different products and business lines and combine the ALM policies appropriately in order to optimise the overall ALM management.

CEIOPS' advice

3.102. The ALM framework shall not only recognise the interdependence between assets and liabilities but also take into account any correlations of risks between different asset classes and any correlations between different products and business lines.

3.103. Undertakings shall also have regard to any off-balance sheet exposures that they may have.

3.104. The undertaking shall develop written ALM policies that especially take into account the interrelation with different types of risks, such as market risks, credit risks, liquidity risks and underwriting risks, establish ways to manage the possible effect of options embedded in the insurance products.

3.105. The ALM policies shall at least provide for:

- a) A structuring of the assets that ensures the undertaking holds sufficient cash and diversified marketable securities of an appropriate nature, term and liquidity to meet its obligations, including obligations to pay bonuses to

policyholders, as they fall due;

- b) A plan to deal with unexpected cash outflows, or changes in expected cash in- and outflows; and
- c) The identification of mitigation techniques and their impact on embedded options, and the assessment of the possible effects these can have throughout the life of the insurance policies and/or reinsurance contracts.

3.106. The undertaking shall tailor its ALM policies to the needs of different products and business lines and combine the ALM policies appropriately in order to optimise the overall ALM management.

- Investment, including derivatives and similar commitments

Explanatory text

3.107. Investments are subject to market risk. Market risk is the risk of loss, or of adverse change in the financial situation, resulting directly or indirectly from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.

3.108. Undertakings shall, according to the “prudent person” principle as specified in Article 132(2) of the Level 1 text, only invest in assets and instruments the risks of which they can properly identify, measure, monitor, manage and control as well as appropriately take into account in the assessment of their overall solvency needs. This requires them to identify assets and investments that are appropriate for them to fulfil the “prudent person” principle.

3.109. When (re)insurance undertakings invest in tradeable securities and other financial instruments originated by ‘repackaged’ loans as referred to in Article 135(2), they should meet additional qualitative requirements. These requirements will be covered by CEIOPS’ Advice on Repackaged Loans Investment⁷.

3.110. Hence undertakings must thoroughly understand the products they want to invest in, and for complex products should preferably use risk management models that consider all relevant variables.

3.111. Further, where the (re)insurance undertaking is taking on a higher risk profile, special management monitoring and controls should be established for complex investments.

3.112. An undertaking should consider all risks arising from its investments and their relationship with its liabilities that are significant in terms of their potential impact on the economic value of its operations.

⁷ See CEIOPS Consultation Paper no. 63 on Repackaged Loans Investment
<http://www.ceiops.eu//index.php?option=content&task=view&id=645>

- 3.113. If the risks arising from the investments are not adequately covered by a sub-module of the standard formula, quantitative limits and asset eligibility criteria may in the future be developed under Level 2 by the Commission in order to address those risks. In any case undertakings should appropriately identify and assess these risks under their ORSA.
- 3.114. CEIOPS does not consider at the present time that such an introduction of regulatory limits on investments is necessary under the Solvency II regime and believes that the prudent person principle is a sufficient requirement to ensure that assets are properly diversified. Accordingly, supervisors would expect to find investment policies in place, including internal quantitative limits set by the undertakings such as for each type of asset 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.
- 3.115. Undertakings need to be more aware of the risks embedded in the assets they are buying or originating. This is particularly important in the case of complex structured products. In this regard it is not sufficient that the undertaking defines internal quantitative limits on assets as the undertaking must still consider the risks included in these complex products.
- 3.116. In order to ensure a proper risk management of investments, the undertaking shall develop a detailed investment strategy that should usefully at least have regard to:
- a) The financial market environment (including historic and anticipated future environment);
 - b) Its solvency position;
 - c) Liquidity risk;
 - d) Concentration risk;
 - e) Credit risk;
 - f) Asset and liability considerations, including interrelation with the asset–liability management strategy;
 - g) Asset classes and strategic asset allocation;
 - h) Conditions under which the undertaking can pledge or lend assets;
 - i) The investment limits set at management level;
 - j) The use of derivatives, asset-backed securities, collateralised debt obligations, hedge funds or any other financial instrument with similar characteristics;
 - k) The link between market risk and other risks in highly adverse scenarios (e.g. a pandemic);
 - l) The independent and appropriate valuation of its investment assets;

- m) Procedures to monitor the performance and review the strategy when necessary; and
 - n) Additional constraints to the investment strategy, such as e.g. P&L targets.
- 3.117. Special management, monitoring and control procedures for the undertaking's investment assets is important, in particular in relation to investments that are not quoted in a market and to complex structured products.
- 3.118. Where mark-to-model valuation is applied, undertakings should devote sufficient resources, both in terms of quality and quantity, to model approval and review, independent price verification and stress testing, as well as to internal control processes. On a regular basis, undertakings should assess the need to develop back-up valuation models for complex or potentially illiquid instruments.
- 3.119. Undertakings need to have access to basic expertise in order to understand, monitor and steer structured products and their embedded risks. Also, the undertaking needs procedures to evaluate hidden and non-standard risks associated with these products, especially new concentration risks that may not be obvious.
- 3.120. Undertakings should understand and be able to evaluate their own investments according to Solvency II valuation principles and should not depend solely on the valuation provided by the financial institution that has initially priced that investment or on a rating assigned by a rating agency.
- 3.121. Regarding holdings of derivative products or any other financial instrument with similar characteristics⁸ ("similar commitments") such as e.g. asset-backed securities, collateralised debt obligations and hedge funds, such instruments should only be used for risk reduction and efficient portfolio management. In this respect, the investment strategy shall clearly identify:
- a) Goals and strategies of the use of derivatives and similar commitments and the way they contribute to an efficient portfolio management;
 - b) The evaluation of the strategy to use this type of products;
 - c) The principles of liquidity risk management for derivatives and similar commitments, including stress tests; and
 - d) The principles of risk management with regard to derivatives and similar commitments.
- 3.122. Exposure limits for counterparty credit risk and risk class for derivatives and similar commitments should be integrated into the overall limits set out in the undertaking's investment strategy.
- 3.123. When undertakings invest in SPVs⁹, either their own SPVs or those established by other (re)insurance undertakings, the following principles should be

⁸ In the context of derivatives, CEIOPS interprets the expression "similar commitments" to refer to financial instruments whose attendant risks are sometimes difficult to determine and whose proper management requires specific expertise.

⁹ This means a SPV according to Article 13 (26) of the Level 1 text.

considered, taking into account the requirements and guidelines set out in CEIOPS' Level 2 Advice on Special Purpose Vehicles¹⁰:

- a) Special ALM procedures should be established as these assets may expose the undertaking to both asset risk (credit spread, market concentration risk, etc.) and to insurance risk as well (if the SPV was established by another (re)insurance undertaking). Specific stress tests may be constructed, namely CAT scenarios; and
- b) Special attention should be given to assets issued by ISPV with whom the undertaking has reinsurance contracts established (self securitisation).

Policy on investment, including derivatives and similar commitments

- 3.124. Compliance with the "prudent person" principle as stipulated according to Article 132(1) of the Level 1 text includes that an investment policy shall be defined based on the rules and procedures that a competent, prudent and expert manager would apply in order to pursue the investment strategy.
- 3.125. The investment policy shall ensure that the undertaking holds assets with sufficient values and enough liquidity to meet all liabilities and enable payments as they fall due. Specifically where the undertaking bears the investment risks, the assets should also be appropriate so that the policyholders are not exposed to undue risk.
- 3.126. The investment policy shall take into account the undertaking's business, its overall risk tolerance levels, the solvency position, the long-term risk versus performance requirements and its underlying exposure (gross and net of offsetting transactions).
- 3.127. When undertakings use derivative products, asset-backed securities and collateralised debt obligations, hedge funds or any other financial instrument with similar characteristics, the investment policy shall take into account the goals and strategies of their use and the way they contribute to an efficient portfolio management, as well as procedures to evaluate the strategy to use this type of products and the principles of risk management to be applied.
- 3.128. In its policy on investment the undertaking shall also consider how to prudently manage liquidity risk, in the short as well as in the medium and long term, taking into account the investment strategy, overall underwriting strategy and claims management strategy.
- 3.129. The investment policy should include internal quantitative limits on assets or exposures, including off-balance sheet exposures, taking into account each type of asset considered eligible by the undertaking, e.g. per counterparty, geographical area or industry.

¹⁰ See CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Special Purpose Vehicles (CEIOPS-DOC-32/09, 2009), <http://www.ceiops.eu/index.php?option=content&task=view&id=584>

CEIOPS' advice

- 3.130. The undertaking shall define its investment policy in line with what a competent, prudent and expert manager would apply in order to pursue the investment strategy.
- 3.131. The investment policy shall take into account the undertaking's business, its overall risk tolerance levels, the solvency position and the long-term risk versus performance requirements and its underlying exposure (gross and net of offsetting transactions).
- 3.132. When undertakings use derivative products or any other financial instrument with similar characteristics, such as asset-backed securities, collateralised debt obligations or hedge funds, the investment policy shall take into account the goals and strategies of their use and the way they contribute to an efficient portfolio management as well as procedures to evaluate the strategy to use these types of products and the principles of risk management to be applied.
- 3.133. In its policy on investment the undertaking shall also consider how to prudently manage liquidity risk in the short as well as in the medium and long term, taking into account the investment strategy, overall underwriting strategy and claims management strategy.
- 3.134. The investment policy shall include internal quantitative limits on assets or exposures, including off-balance sheet exposures, taking into account each type of asset considered eligible by the undertaking.
- 3.135. Special management, monitoring and control procedures shall be established, in particular in relation to investments that are not quoted in a market and to complex structured products.

- Liquidity risk management

Explanatory text

- 3.136. Liquidity risk refers to the risk that undertakings are unable to realise investments and other assets in order to settle their financial obligations when they fall due.
- 3.137. Liquidity in this context is the availability of funds, or certainty that funds will be available without significant losses, to honour all cash outflow commitments (both on and off-balance sheet) as they fall due. These commitments are generally met through cash inflows, supplemented by assets readily convertible to cash.
- 3.138. It is the undertaking's responsibility to have sound liquidity management practices which cover both short and long term considerations and include stress tests and scenario analyses.
- 3.139. Short term liquidity, or cash management, covers the day-to-day cash requirements under normally expected or likely business conditions. Liquidity

considerations over a long term need to be assessed in a way which recognises the possibility of various unexpected and potentially adverse business conditions where asset values may not be realised for current market values.

- 3.140. The undertaking shall have in place a liquidity contingency plan that includes:
- a) The continuous monitoring of the undertaking's debt position and analysis of the undertaking's debt capacity;
 - b) The identification of the available financing options, including reinsurance, the negotiation of credit lines, committed borrowing facilities and intra-group financing;
 - c) A regular review and testing of these options, both in normal and adverse situations.
- 3.141. In order to ensure a proper risk management of the liquidity risk the undertaking should develop a detailed strategy that should usefully have regard to at least:
- a) The level of mismatch between the cash inflows and the cash outflows of both assets and liabilities;
 - b) The level of mismatch of the expected cash flows of direct insurance and reinsurance;
 - c) The total liquidity needs in the short and medium term including an appropriate buffer for liquidity shortfall;
 - d) The level and monitoring of liquid assets, including a quantification of potential costs or financial losses arising from an enforced realisation;
 - e) The cost of financing and the identification of other financing tools and the associated costs; and
 - f) Projections of cash outflows arising from the insurance activity, such as claims, lapses or surrenders, and evaluation of the uncertainty of timing and amount of the insurance liabilities and of expected new business.

CEIOPS' advice

3.142. It is the undertaking's responsibility to have sound liquidity management practices which cover both short term and long term considerations and include stress tests and scenario analyses.

- 3.143. The undertaking shall have in place a liquidity contingency plan that includes:
- a) The continuous monitoring of the undertaking's debt position and analysis of the undertaking's debt capacity;
 - b) The identification of the available financing options, including reinsurance, the negotiation of credit lines, committed borrowing facilities and intra-group financing;

- c) A regular review and testing of these options, both in normal and adverse situations.

Concentration risk management

Explanatory text

- 3.144. Concentration risk means all risk exposures with a loss potential which is large enough to threaten the solvency or the financial position of undertakings.
- 3.145. Such exposures may be caused for example by credit risk, market risk, underwriting risk, liquidity risk, other risks, or a combination or interaction of those risks by counterparty, industry or geographical area.
- 3.146. As part of the approach to concentration risk, the undertaking should develop a detailed strategy that, at a minimum, should take account of:
- a) Policies on underwriting;
 - b) Investments; and
 - c) Reinsurance and other risk mitigation techniques.
- 3.147. Concentration risk can arise in both the assets and liabilities sides of the balance sheet of the undertaking, as well as in off-balance sheet items and can originate from a series of sources, including geographical areas, (entity or group) counterparties, economic sectors, types of products, providers of services, reinsurance and cumulative exposures in the insurance contracts (both explicit and embedded).
- 3.148. In order to properly manage concentration risk, undertakings shall define the sources of risk concentration relevant for their portfolios. Examples include exposures emanating from specific economic sectors or geographical areas. Undertaking shall make use of internal limits, thresholds or similar concepts that are appropriate with regard to their overall risk management.
- 3.149. Undertakings need to have in place adequate procedures and processes for the active monitoring and management of concentration risk to ensure that it stays within established policies and limits and mitigating actions can be taken as necessary. The monitoring of concentration risk shall include an analysis of possible contagion lines.
- 3.150. Where it is proportionate to the nature, scale and complexity of an undertaking's risk profile it should consider common or correlating underlying factors in order to identify correlations in the probability of defaults or risks crystallizing.

CEIOPS' advice

- 3.151. In order to properly manage concentration risk, undertakings shall define the

sources of risk concentration relevant for their portfolios. Undertakings shall make use of internal limits, thresholds or similar concepts that are appropriate with regard to their overall risk management.

- 3.152. Undertakings need to have in place adequate procedures and processes for the active monitoring and management of concentration risk to ensure that it stays within established policies and limits and mitigating actions can be taken as necessary. The monitoring of concentration risk shall include an analysis of possible contagion lines.

Operational risk management

Explanatory text

- 3.153. While defining the requirements for the management of operational risk, CEIOPS has taken into account the main conclusions that were achieved as a result of the questionnaire on operational risk that was presented to undertakings in the context of the QIS4 exercise. These conclusions, as published in the QIS4 Report¹¹, are presented in Annex A.
- 3.154. Operational risk refers to the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events.
- 3.155. As set out in Article 101(4) of the Level 1 text, this definition includes legal risk, but excludes risks arising from strategic decisions and reputation risk. The definition does not preclude undertakings from articulating what constitutes operational risk differently for the purposes of the undertakings' operational risk policies and procedures.
- 3.156. The undertaking should have a well-documented assessment and management system for operational risk, with clear responsibilities assigned.
- 3.157. The administrative, management or supervisory body should be aware of the major categories and exposures of the undertaking's operational risks as a distinct risk category that should be managed, and should approve, oversee implementation and regularly review the undertaking's operational risk management framework.
- 3.158. This framework should include:
- a) An undertaking-wide definition of operational risk. Without prejudice to the definition given above, undertakings shall articulate what constitutes operational risk for the purposes of their policies and procedures;
 - b) Effective processes to identify, assess, mitigate, manage, monitor and report the operational risks the undertaking is, or might be, exposed to and adequate internal control mechanisms; and

¹¹ CEIOPS' Report on its fourth Quantitative Impact Study (QIS4) for Solvency II, CEIOPS-SEC-82/08, November 2008, <http://www.ceiops.eu/media/files/consultations/QIS/CEIOPS-SEC-82-08%20QIS4%20Report.pdf>.

- c) The arrangements, processes and mechanisms detailed above should be comprehensive and proportionate to the nature, scale and complexity of the undertaking's activities.
- 3.159. In order to ensure a proper risk management of operational risk, the undertaking should develop a detailed strategy that should usefully take into account:
- a) The entire activities and internal processes in place in the undertaking, including any IT system supporting them;
 - b) The operational risk events it is or might be exposed to and the way to mitigate them;
 - c) The need for an early warning system that allows for an effective intervention.
- 3.160. The undertaking shall implement an effective process to regularly identify, document and monitor exposure to operational risk and track relevant operational risk data, including near misses.
- 3.161. CEIOPS would expect undertakings to systematically collect operational risk data in an internal data base or a loss data register.
- 3.162. Effective operational risk identification should consider the undertaking's business environment and internal control factors, including:
- a) Internal factors, such as the undertaking's structure, the nature of its activities, products and processes, the quality of its human resources, organisational changes and employee turnover; and
 - b) External factors, including changes in the industry, the legal environment and technological developments that could adversely affect the achievement of the undertaking's objectives and its operational risk profile.
- 3.163. In order to better manage the operational risks the undertaking is exposed to, notably through the analysis and projections of values, the identification of operational risk events should also comprise its categorisation¹².
- 3.164. In addition to identifying its exposure to high severity events, the undertaking should assess its vulnerability to these risks through stress and scenario testing. Over time such assessments must be validated and re-assessed through comparison to actual loss experience to ensure their reasonableness.
- 3.165. The operational risk management framework needs to be closely integrated into the risk management processes of the undertaking. Its output must be an integral part of the process of monitoring and controlling the undertaking's operational risk profile.

¹² One example of an operational risk categorisation that is widely used by (re)insurance undertakings is the one proposed by the Operational Risk Insurance Consortium (ORIC, see footnote in annex A), which is based on the Capital Requirements Directive (2006/48/EC). However, every undertaking should be free to choose the operational risk categorisation that best suits its needs and risk exposures/profile.

CEIOPS' advice

- 3.166. The undertaking shall have a well-documented assessment and management system for operational risk, with clear responsibilities assigned.
- 3.167. The administrative, management or supervisory body shall be aware of the major aspects of the undertaking's operational risks as a distinct risk category that shall be managed, and shall approve, oversee implementation and regularly review the undertaking's operational risk management framework.
- 3.168. The undertaking shall implement an effective process to regularly identify, document and monitor exposure to operational risk and track relevant operational risk data, including near misses.
- 3.169. The operational risk management framework needs to be closely integrated into the risk management processes of the undertaking. Its output must be an integral part of the process of monitoring and controlling the undertaking's operational risk profile.

Risk mitigation techniques

Reinsurance and similar risk mitigation techniques

Explanatory text

- 3.170. Reinsurance and similar risk mitigation techniques may enable the undertaking to prudently manage and mitigate in particular the insurance specific risk. However, they also carry new potential risks, such as the risk of counterparty default.
- 3.171. 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 preset risk tolerance levels. Such arrangements can consist of traditional reinsurance, involving the transfer of insurance risk through conventional carriers and products, as well as non-traditional (or financial¹³) reinsurance, contingent loans and securitisations which are both addressed in CEIOPS' advice on reinsurance management¹⁴.
- 3.172. In this section when reference is made to reinsurance, unless otherwise specified, it also includes other similar risk mitigation techniques that have the economic

¹³ Financial or finite reinsurance is a generic term that is used to describe an entire spectrum of reinsurance arrangements that transfer limited risk relative to aggregate premiums that could be charged under the contract. Although there is no accepted global definition, a typical transaction may include, but need not be limited to, provisions for aggregating risk, for aggregating limits of liabilities, for aligning the interests of undertakings, and for explicitly recognising the time value of money.

¹⁴ See Answers to the European Commission on the second wave of Calls for Advice in the framework of the Solvency II project, Cfa 12, http://www.ceiops.eu/media/files/publications/submissionstotheec/Doc07_05-AnswersEC2ndwaveSII.pdf

effect of reinsurance. This section does not cover financial risk mitigation techniques, as these are covered in the following section.

- 3.173. A reinsurance management strategy shall be defined and properly documented. Undertakings should identify who is responsible for monitoring the reinsurance arrangements, which control mechanisms are in place and what reporting lines are established.
- 3.174. As part of their reinsurance management strategy, undertakings should have adequate procedures and processes for the selection of suitable reinsurance programs. The level of sophistication for these processes and procedures should be proportionate to the nature, scale and complexity of the undertaking's risks and to the capabilities of the undertaking to manage and control the risk mitigation technique used.
- 3.175. The undertaking's reinsurance management strategy should usefully have regard to the following considerations:
 - a) Identification of the level of risk transfer appropriate to the undertaking's approach to risk;
 - b) What types of reinsurance arrangements are most appropriate to limit risks to the undertaking's insurance risk profile;
 - c) Principles for the selection of reinsurance counterparties;
 - d) Procedures for assessing the creditworthiness and diversification of reinsurance counterparties;
 - e) Procedures for assessing the effective risk transfer;
 - f) Concentration limits for credit risk exposure to reinsurance counterparties and appropriate systems for monitoring these exposures; and
 - g) Liquidity management to deal with any timing mismatch between claims' payments and reinsurance recoveries.
- 3.176. The reinsurance management strategy should include provisions to regularly review the procedures and processes established in order to ensure that they remain efficient and effective and take into account relevant changes in the risk profile of the undertaking.
- 3.177. Undertakings have to assess the effectiveness of all risk mitigation techniques employed, whether they use reinsurance, SPVs, or any other similar technique, in order to ensure that they meet their risk mitigation objectives. The undertaking has to document the assessment and to introduce changes to the risk mitigation as necessary to improve its effectiveness.
- 3.178. The undertaking should develop a written analysis of the functioning and inherent material risks of the risk mitigation techniques used. In particular, subject to the principle of proportionality, it should document the legal, liquidity/termination or other risks that can derive from the risk mitigation technique, the actions adopted to face such risks and the potential consequences of the risks (i.e. in a worst-case scenario). Examples of risks to be considered for

this purpose are legal risk, counterparty default risk, basis risk and operational risks specific to the technique¹⁵.

Special features regarding SPVs

- 3.179. As SPVs differ from reinsurance undertakings the Level 1 text (Article 211) requires that additional Level 2 requirements should be provided for the authorisation and supervision of the SPVs. CEIOPS has therefore, in parallel to this Advice, developed Advice on Level 2 implementing measures on a regime for SPVs that protects policyholders of undertakings while at the same time not preventing innovation in the insurance industry¹⁶.
- 3.180. When undertakings use SPVs the following principles should be considered taking into account the requirements and guidelines set out in the Advice referred to above¹⁷:
- a) The fully funded requirement should be actively monitored by the undertaking through its system of governance;
 - b) Any remaining risk (credit, market, liquidity, operational risk or 'burn-through' that may occur if the insured cost were to exceed the maximum amount payable by the SPV) from the SPV should be fully taken into account in the undertaking through its risk management system and also taken into account within the calculation of its regulatory capital requirements. The undertaking should be particularly aware of any residual insurance risk arising from the SPV if there were losses in excess of those envisaged at the time of authorisation. These losses above the funding provided would revert back to the undertaking;

CEIOPS' advice

3.181. As part of their reinsurance management strategy, undertakings shall have adequate procedures and processes for the selection of suitable reinsurance programs. The level of sophistication for these processes and procedures shall be proportionate to the nature, scale and complexity of the undertaking's risks and to the capabilities of the undertaking to manage and control the risk mitigation technique used.

3.182. The undertaking's reinsurance management strategy shall usefully have regard to the following considerations:

- a) Identification of the level of risk transfer appropriate to the undertaking's approach to risk;

¹⁵ See CEIOPS' Advice for Level 2 Implementing Measures on SCR formula – Allowance of financial mitigation techniques (CEIOPS-DOC-26/09, 2009), <http://www.ceiops.eu/index.php?option=content&task=view&id=579>.

¹⁶ See CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Special Purpose Vehicles (CEIOPS-DOC-32/09, 2009), <http://www.ceiops.eu/index.php?option=content&task=view&id=584>

¹⁷ See CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Special Purpose Vehicles (CEIOPS-DOC-32/09, 2009), <http://www.ceiops.eu/index.php?option=content&task=view&id=584> .

- b) What types of reinsurance arrangements are most appropriate to limit risks to the undertaking's insurance risk profile;
- c) Principles for the selection of reinsurance counterparties;
- d) Procedures for assessing the creditworthiness and diversification of reinsurance counterparties;
- e) Procedures for assessing the effective risk transfer;
- f) Concentration limits for credit risk exposure to reinsurance counterparties and appropriate systems for monitoring these exposures; and
- g) Liquidity management to deal with any timing mismatch between claims' payments and reinsurance recoveries.

3.183. When undertakings use SPV's the following principles shall be considered taking into account the requirements and guidelines set out in CEIOPS' Level 2 Advice on Special Purpose Vehicles:

- a) The fully funded requirement shall be actively monitored by the undertaking through its system of governance;
- b) Any remaining risk from the SPV shall be fully taken into account in the undertaking through its risk management system and also taken into account within the calculation of its regulatory capital requirements.

Financial risk mitigation techniques

Explanatory text

3.184. CEIOPS' Level 2 Advice¹⁸ on Implementing Measures on SCR formula - Allowance of financial risk mitigation techniques includes additional requirements on the system of governance to (re)insurance undertakings that use financial risk mitigation techniques. The following paragraphs should be considered in conjunction with the referred Advice¹⁹.

3.185. Financial risk mitigation techniques should only be used where it is appropriate to do so as part of an overall risk management policy and reinsurance management strategy, where both qualitative and quantitative features shall be appropriately considered.

3.186. Financial risk mitigation techniques should not be applied with the primary aim of

¹⁸ Please refer to footnote 15.

¹⁹ From a Level 2 advice and legal drafting point of view the governance requirements should be included in this Advice, but from a practical point of view CEIOPS decided to keep these requirements in CEIOPS' Level 2 Advice on Implementing Measures on SCR formula - Financial Risk Mitigation Techniques" – see footnote 15.

achieving a reduction of an undertaking's SCR, but be applied as part of an undertaking's broader risk management system, having regard to its desired risk profiles, assumed and retained, both in benign and in stressed situations. Undertakings should assess this as part of their ORSA.

- 3.187. It is the responsibility of each undertaking to assess which type of financial mitigation technique is appropriate according to the nature of the risks assumed and the capabilities of the undertaking to manage and control the risks associated with that technique. CEIOPS expects undertakings to document their assessment taking into account the considerations discussed in paragraph 3.178.

CEIOPS' advice

3.188. Financial risk mitigation techniques shall only be used where it is appropriate to do so as part of an overall risk management policy and reinsurance management strategy, where both qualitative and quantitative features shall be appropriately considered.

3.189. Financial risk mitigation techniques must not be applied with the primary aim of achieving a reduction of an undertaking's SCR, but be applied as part of an undertaking's broader risk management system, having regard to its desired risk profiles, assumed and retained, both in benign and in stressed situations. Undertakings shall assess this as part of their ORSA.

3.190. It is the responsibility of each undertaking to assess which type of financial mitigation technique is appropriate according to the nature of the risks assumed and the capabilities of the undertaking to manage and control the risks associated with that technique.

Some other risks to be considered

Credit risk management

Explanatory text

3.191. Credit risk refers to the risk of loss, or of adverse change in the financial situation resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which insurance and reinsurance undertakings are exposed, in the form of counterparty default risk, or spread risk, or market risk concentrations.

3.192. This risk is not explicitly mentioned in Article 44(2) of the Level 1 text, but is included in the calculation of the SCR.

3.193. Credit risk is a function of exposure at default, probability of default and loss given default. A credit risk management strategy should, at a minimum, focus on these elements both in isolation and on the correlations between them.

- 3.194. The undertaking should ensure that the credit risk exposure is sufficiently diversified. It should have a process of credit risk management to ensure that exposure to any counterparty is limited so that no single exposure would threaten the undertaking's solvency position.
- 3.195. The process of risk management should be capable of identifying, measuring and mitigating any credit risk in relation to internally defined limits.
- 3.196. The undertaking should be alert to changes in individual credit ratings as well as credit portfolio risk through regular appropriate and proportionate monitoring processes, and capable of evaluating relevant parameters like probabilities of default even where exposures are unrated. Exposure to speculative grade assets should be prudent and undertakings facing larger credit risk exposures should be capable of hedging credit risk, e.g. via derivatives to protect against a protracted fall in credit quality or turn in the credit cycle.
- 3.197. Undertakings should be aware that intra group exposures give rise to credit risk as any other external exposure does. The undertaking should be able to demonstrate that it is not overly reliant on any counterparty, regardless of whether it lies within the same group.

CEIOPS' advice

- 3.198. The process of risk management shall be capable of identifying, measuring and mitigating any credit risk in relation to internally defined limits.
- 3.199. The undertaking shall be alert to changes in individual credit ratings as well as credit portfolio risk through regular appropriate and proportionate monitoring processes, and capable of evaluating relevant parameters like probabilities of default even where exposures are unrated. Exposure to speculative grade assets shall be prudent and undertakings facing larger credit risk exposures shall be capable of hedging credit risk, e.g. via derivatives to protect against a protracted fall in credit quality or turn in the credit cycle.
- 3.200. The following other risks not explicitly mentioned in Article 44 of the Level 1 text should be considered in particular due to the potential impact their crystallisation could have on the business of the undertaking:
- a) Strategic risk; and
 - b) Reputational risk.

Strategic risk

Explanatory text

- 3.201. Strategic risk is defined as the risk of the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.

- 3.202. 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 and the resources deployed to achieve these goals, and the quality of implementation and the economic situation of the markets the undertaking operates in.
- 3.203. 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 should be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.
- 3.204. The overall strategy of the undertaking should incorporate its risk management practices. In this sense, the undertaking should have a process for setting strategic high-level objectives and translating these into detailed shorter-term business and operation plans.

Reputational risk

Explanatory text

- 3.205. Reputational risk is defined as the risk of potential loss to an undertaking through deterioration of its reputation or standing due to a negative perception of the undertaking's image among customers, counterparties, shareholders and/or supervisory authorities. To that extent it may be regarded as less of a separate risk, than one consequent on the overall conduct of an undertaking.
- 3.206. The administrative, management or supervisory body of the undertaking should be aware of potential reputational risks it is exposed to and the correlation with all other material risks.
- 3.207. The undertaking should pay great attention to understanding and recognising key values affecting reputation, considering expectations of the stakeholders and sensitivity of the marketplace.

Risk management function

Explanatory text

3.208. Article 44(4) and (5) of the Level 1 text states:

4. Insurance and reinsurance undertakings shall provide for a risk-management function which shall be structured in such a way as to facilitate the implementation of the risk-management system.

5. For insurance and reinsurance undertakings using a partial or full internal model approved in accordance with Articles 112 and 113 the risk-management function shall cover the following additional tasks:

(a) to design and implement the internal model;

(b) to test and validate the internal model;

(c) to document the internal model and any subsequent changes made to it;

(d) to analyse the performance of the internal model and to produce summary reports thereof;

(e) to inform the administrative, management or supervisory body about the performance of the internal model, suggesting areas needing improvement, and up-dating that body on the status of efforts to improve previously identified weaknesses.

3.209. The undertaking needs to establish a risk management function within its organisational structure that is proportionate to the scale, nature and complexity of risks inherent within the business. The embedding of the risk management function in the organisational structure of the undertaking and the associated reporting lines shall ensure that the function is objective and free from influence from other functions and from the administrative, management or supervisory body.

3.210. The administrative, management or supervisory body is collectively responsible for ensuring that the implemented risk management system is suitable, effective and proportionate to the nature, scale and complexity of the risks inherent in the business. Notwithstanding, owing to the importance of risk management within Solvency II, CEIOPS believes that undertakings should designate at least one member of the administrative, management or supervisory body to oversee the risk management function²⁰. CEIOPS acknowledges that in large undertakings and in undertakings with more complex risk profiles, having regard to the principle of proportionality, the person responsible for the risk management function is sometimes designated as a Chief Risk Officer (CRO).

3.211. The risk management function is responsible for the coordination across the undertaking of risk management activities.

²⁰ In CEIOPS' view the undertaking could establish a risk committee with the task of focusing on risk management issues.

- 3.212. The tasks of the risk management function include:
- a) Assisting the administrative, management or supervisory body and other management in the effective operation of the risk management system, in particular by performing specialist analysis and performing quality reviews;
 - b) Monitoring the risk management system;
 - c) Maintaining an organisation-wide and aggregated view on the risk profile of the undertaking;
 - d) Reporting details on risk exposures and advising the administrative, management or supervisory body with regard to risk management matters in relation to strategic affairs such as corporate strategy, mergers and acquisitions and major projects and investments; and
 - e) Identifying and assessing emerging risks.
- 3.213. The design and operational effectiveness of the risk management system to identify, measure, monitor, manage and report risks the undertaking is exposed to shall be regularly evaluated by the risk management function.
- 3.214. Article 44(5) requires the risk management function to take on board a set of additional tasks that relate to the use of partial or full internal models. By contrast the Level 1 text does not explicitly assign any specific task with regard to internal models to the actuarial function although the actuarial function is required to contribute to the effective implementation of the risk management system, which includes the internal model. CEIOPS understands the Level 1 text to assign "ownership" of an internal model to the risk management function. The concept aims to ensure that the model is designed and maintained as an effective risk management tool and is more than a calculation kernel. Since the Level 1 text does not distinguish between different parts of the internal model, CEIOPS interprets this to mean that the risk management function is responsible for the design, maintenance and monitoring, but this does not preclude the risk management function from calling upon expertise from other functions, notably the actuarial.
- 3.215. If the undertaking uses an internal model, this is part of a comprehensive risk management system which should have adequate resources and structures to ensure that the internal model is and stays appropriate to the undertaking's risk profile.
- 3.216. In this context, the risk management function shall be responsible for the way in which the internal model is designed and integrated with the undertaking's internal risk management system and the day-to-day functions of the undertaking. It shall assess the internal model as a tool of risk management and as a tool to calculate the undertaking's SCR.
- 3.217. Article 116 states that the administrative, management or supervisory body shall have responsibility for putting in place systems which ensure that the internal model operates properly on a continuous basis. As part of this process, the risk management function should regularly test and validate the internal model with a view to identify weaknesses, to improve the model and to ensure

that the model remains appropriate to the risk profile of the undertaking.

- 3.218. Documentation of the internal model, and any subsequent changes to it, should be owned by the risk management function so that these are explained in the context of the risk management system.
- 3.219. The information about the performance of the internal model that the risk management function is required to give to the administrative, management or supervisory body according to Article 44(5)(d) should be properly documented. These reports should be tailored to the needs of the administrative, management or supervisory body, enabling its members to understand all relevant facts and the implications following from them as a solid and reliable basis for necessary management decisions, as well as in their role for being responsible for the on-going appropriateness of the design and operations of the internal model, and that the internal model continues to reflect the risk profile of the undertaking²¹.

CEIOPS' advice

- 3.220. The undertaking shall embed the risk management function in the organisational structure and organise the associated reporting lines in a manner which ensures that the function is objective and free from influence from other functions and from the administrative, management or supervisory body.
- 3.221. The tasks of the risk management function shall include:
- a) Assisting the administrative, management or supervisory body and other management in the effective operation of the risk management system, in particular by performing specialist analysis and performing quality reviews;
 - b) Monitoring the risk management system;
 - c) Maintaining an organisation-wide and aggregated view on the risk profile of the undertaking; and
 - d) Reporting details on risk exposures and advising the administrative, management or supervisory body with regard to risk management matters in relation to strategic affairs like corporate strategy, mergers and acquisitions and major projects and investments; and
 - e) Identifying and assessing emerging risks.
- 3.222. The risk management function shall be responsible for the way in which an internal model is integrated with the undertaking's internal risk management system and the day-to-day functions of the undertaking. It shall assess the internal model as a tool of risk management and as a tool to calculate the undertaking's SCR.

²¹ See CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Tests and Standards for Internal Model Approval, <http://www.ceiops.eu/index.php?option=content&task=view&id=607>.

3.4. Internal Control

Explanatory text

3.223. Article 46 of the Level 1 text states:

1. Insurance and reinsurance undertakings shall have in place an effective internal control system.

That system shall at least include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the undertaking and a compliance function.

2. The compliance function shall include advising the administrative, management or supervisory body on compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive. It shall also include an assessment of the possible impact of any changes in the legal environment on the operations of the undertaking concerned and the identification and assessment of compliance risk.

3.224. A system of effective internal control is a critical component of undertaking management and a foundation for the safe and sound operation of undertakings. Internal control is not a procedure or policy performed at a certain point in time, but rather a set of continually operating processes involving the administrative, management or supervisory body and all levels of personnel.

3.225. There are different frameworks in force for the internal control system. The Level 1 text does not prescribe any specific approach and CEIOPS has no expectation that undertakings prefer any specific framework.

3.226. In CEIOPS' view, an effective internal control system, as envisaged in the Level 1 text, shall comprise a coherent, comprehensive and continuous set of mechanisms designed to secure at least the following:

- a) Effectiveness and efficiency of the undertaking's operations in view of its risks and objectives;
- b) Availability and reliability of financial and non-financial information; and
- c) Compliance with applicable laws, regulations and administrative provisions.

3.227. Internal control is defined as a process affected by an organisation's structure, work and authority flows, people and management information systems, designed to help the organisation accomplish specific goals or objectives²².

3.228. The internal control system should be suitable to the individual characteristics of each undertaking, such as the degree of centralisation, delegation of authority

²² The definition is taken from COSO, see <http://www.coso.org/IC-IntegratedFramework-summary.htm>. This does however not imply that CEIOPS advocates the use of the COSO Framework.

and the capacity and effectiveness of the information technologies, in particular taking into account the scale, nature and complexity of the business. The activities of the undertaking should determine how strong different features of the internal control framework need to be.

- 3.229. The internal control system should ensure that an undertaking's systems, whether manual or based on information technology, are appropriate to the undertaking's strategies and data needs and consistent with the nature and complexity of its activities.
- 3.230. Appropriate administrative procedures shall be defined and implemented for the main activities within the undertaking in order to ensure well-ordered and efficient operations, to reduce mistakes in the handling of business and to support compliance with applicable rules and regulations. Examples of such administrative procedures include procedures for the implementation and maintenance of accounting policies and procedures which ensure that accounts give a true and fair view of an undertaking's assets and liabilities, as well as its financial position, internal programmes, procedures and controls to combat money laundering and terrorist financing, and systems to deal with policyholders' claims and complaints.
- 3.231. An effective internal control system should comprise robust and efficient control activities at all levels of the undertaking. These should be implemented by the management in line with the strategies, business plans and goals set for the undertaking. As an integrated part of daily business, the control activities should be reviewed and documented on an on-going basis.

Control environment

- 3.232. The internal control system of the undertaking should be built upon a strong control culture which emphasises and demonstrates to all levels of personnel the importance of internal control.
- 3.233. A high level of integrity is an essential part of the control culture. In reinforcing integrity, undertakings should avoid policies and practices that may provide incentives for inappropriate activities.
- 3.234. As stated in Article 41(3) of the Level 1 text, the undertaking needs to implement a written policy on internal control that is approved by the administrative, management or supervisory body. This should include the means by which senior management implement the internal control system to provide for and maintain the suitability and effectiveness of the internal control system.
- 3.235. The provision that calls for the regular internal review of the system of governance is necessarily applicable to that system.
- 3.236. The undertaking's systems should also take account of applicable data protection requirements, provide for appropriate security controls and should at least cover access to hardware, systems and data, so as to maintain the integrity of records and information and thereby protect the interests of policyholders. Managerial, operational and technical controls could also be included, as

necessary.

Control activities

- 3.237. The daily control activities could, depending on the particular circumstances of the undertaking, include approvals, authorisations, verifications, reconciliations, management reviews, appropriate measurements applicable to each business area and unit, physical controls, checking for compliance with agreed exposure limits and operating principles/instructions and follow-up on non-compliance. The control activities should be proportionate to the risks coming from the controlled activities and processes.
- 3.238. Controls should also ensure that any areas of potential conflicts of interest are identified and managed appropriately.

Communication

- 3.239. Clear reporting and communication lines shall be set up. The reporting of the achievement of the main goals and material risks inherent in the business should be predefined. This applies particularly to the reporting to the administrative, management or supervisory body.
- 3.240. Communication lines inside the undertaking should also encourage adverse reporting, particularly when flowing upwards, so as to avoid employees suppressing negative information and permit the jumping of reporting lines should the situation call for such action. Quality reports, timely reporting, accuracy, completeness and suggestions for improvements should also be encouraged.

Monitoring

- 3.241. The monitoring mechanisms shall facilitate the understanding of the undertaking's situation and provide the administrative, management or supervisory body with relevant information for the decision-making process. They should include procedures to detect deficiencies.
- 3.242. Ongoing monitoring should occur in the course of normal operations and should include regular management activities and actions taken by all personnel when performing their duties.
- 3.243. The effectiveness of the internal control system itself should be monitored on a continuous basis, so that any deficiencies of the system can be identified and rectified in a timely manner.

Compliance function

- 3.244. The compliance function within the undertaking is the administrative capacity for ensuring that all the actions of the undertaking comply with applicable laws and regulatory requirements. The compliance function could also ensure that the undertaking complies with internal strategies, policies, processes and reporting procedures.
- 3.245. Article 46(1) requires undertakings to have in place a compliance function as part of the internal control system. It should identify, assess, monitor and report the compliance risk exposure of the undertaking.
- 3.246. Compliance risk is defined as the risk of legal or regulatory sanctions, material financial loss or loss to reputation an undertaking may suffer as a result of not complying with laws, regulations and administrative provisions as applicable to its activities.
- 3.247. In order to assess the possible impact of significant changes in the legal environment that the undertaking operates in, as well as identify and assess the compliance risk that could arise from such changes, the compliance function should monitor projected revisions of legislation and plans to introduce new regulation and assess their potential impact on the undertaking and monitor the relevant court decisions.
- 3.248. According to Article 46(2) the tasks of the compliance function require as a minimum advising the administrative, management or supervisory body on compliance with the applicable laws, regulations and administrative provisions adopted pursuant to the Level 1 text. The compliance function could also ensure that the undertaking complies with other applicable laws and regulations whether insurance specific or not.
- 3.249. The responsibilities of the compliance functions, along with its competences and reporting duties, should be set out in the internal control policy or another formal document.
- 3.250. The compliance function should assess the appropriateness of the undertaking's compliance procedures and guidelines, follow up identified deficiencies promptly and make suggestions for improvements as necessary.
- 3.251. The compliance function shall be able to communicate on its own initiative with any staff member and to obtain access to any records necessary to allow it to carry out its responsibilities.
- 3.252. The intended compliance activities shall be set out in a compliance plan that ensures that all relevant areas of the undertaking are appropriately covered, taking into account their susceptibility to compliance risk.
- 3.253. The compliance function shall promptly report any major compliance problems it identifies to the administrative, management or supervisory body.

CEIOPS' advice

- 3.254. The internal control system shall secure the undertaking's compliance with applicable laws, regulations and administrative provisions and the effectiveness and efficiency of operations in view of its objectives as well as the availability and reliability of financial and non-financial information.
- 3.255. The undertaking shall be required to have in place a suitable control environment, appropriate control activities, effective information and communication procedures and adequate monitoring mechanisms.
- 3.256. The compliance function shall be able to communicate on its own initiative with any staff member and to obtain access to any records necessary to allow it to carry out its responsibilities.
- 3.257. The intended compliance activities shall be set out in a compliance plan that ensures that all relevant areas of the undertaking are appropriately covered, taking into account their susceptibility to compliance risk.
- 3.258. The compliance function shall promptly report any major compliance problems it identifies to the administrative, management or supervisory body.

3.5. Internal Audit

Explanatory text

3.259. Article 47 of the Level 1 text states:

1. Insurance and reinsurance undertakings shall provide for an effective internal audit function.

The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance.

2. The internal audit function shall be objective and independent from the operational functions.

3. Any findings and recommendations of the internal audit shall be reported to the administrative, management or supervisory body which shall determine what actions are to be taken with respect to each of the internal audit findings and recommendations and shall ensure that those actions are carried out.

3.260. The internal audit function is an independent function within the organisation which examines and evaluates the functioning of the internal controls and all other elements of the system of governance, as well as the compliance of activities with internal strategies, policies, processes and reporting procedures.

3.261. The internal audit function needs to be independent from the organisational activities audited and carry out its assignments with impartiality. The principle of independence entails that the internal audit function should only operate under the oversight of the administrative, management or supervisory body, reporting

to this body or an audit committee. At the same time it has to be ensured that the internal audit function is not subject to instructions of the administrative, management or supervisory body when performing the audit and when evaluating and reporting the audit results. Only the right to change and approve audit plans remains unaffected by the required abstention from issuing instructions.

- 3.262. To ensure the effectiveness of the internal audit function it is further necessary to endow the function with sufficient resources.
- 3.263. The internal audit function shall be able to exercise its assignment without impairment in all areas of the undertaking and to this purpose have direct communication with all members of staff. It shall be free to express its opinion and to disclose its findings and appraisals to the whole administrative, management or supervisory body.
- 3.264. The position/status of the internal audit function within the undertaking should be set up in a formal document by the administrative, management or supervisory body or with its approval, e.g. in an internal audit charter or in an internal audit strategy document. This should at least cover the following aspects:
 - a) Objective and scope of the internal audit function;
 - b) Status within the undertaking; and
 - c) Competences/tasks and responsibilities.
- 3.265. The internal audit function needs to be provided with a complete and unrestricted right to obtain information, which includes the prompt provision of all necessary information, the availability of all essential documentation and the ability to see into all activities and processes of the undertaking, relevant for the discharge of its responsibilities. It needs to be granted access to any records, files or data of the undertaking, including management information and the minutes of decision-making bodies whenever relevant for the performance of its tasks.
- 3.266. All business units should have an obligation to inform the internal audit function when control deficiencies are recognised, losses are sustained or there is a definite suspicion concerning irregularities. The internal audit function should define the appropriate parameters/triggers for this obligation.
- 3.267. Having regard to the principle of proportionality, CEIOPS considers that in large undertakings and in undertakings with more complex risk profiles the establishment of an audit committee would be the adequate solution.
- 3.268. The internal audit function should prepare an audit plan setting out the audit work to be undertaken in the upcoming business year(s). The audit plan should be based on a methodical risk analysis, taking into account all activities and the complete system of governance, as well as expected developments of activities and innovations. On the basis of the result of this risk analysis, a plan, extending for several years depending on the scale and complexity of the activities, should be established.

- 3.269. In the planning of audit activities the internal audit function needs to ensure that all significant activities are reviewed within a reasonable period of time (audit cycle principle) and proper consideration should be given to how often important areas of the undertaking need to be scrutinised.
- 3.270. The audit plan should be realistic and detail the necessary resources and budget. It should be submitted for approval to the administrative, management or supervisory body.
- 3.271. The audit activities should be complemented by an adequate follow-up procedure in order to keep track of remedial actions taken by management in areas where shortcomings were observed by the internal audit function.
- 3.272. Good practice suggests that the internal audit function should issue written reports and transmit these promptly to the managers of the audited units regardless of whether material shortcomings have been found. Reports should in any case be produced if deficiencies are identified in an audited area and also be transmitted to the administrative, management or supervisory body in the case of major deficiencies.
- 3.273. This notwithstanding, the internal audit function shall at least annually produce a written report on its finding to be submitted to the administrative, management or supervisory body. The report shall cover 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 shall include recommendations on how to remedy inadequacies and also specifically address how past points of criticism and past recommendations have been followed up.
- 3.274. The internal audit function should also report to the administrative, management or supervisory body on the achievement of the internal audit function's objectives, in particular, on the execution of the audit plan. As part of its supervisory task, the administrative, management or supervisory body should regularly discuss the organisation, audit plan, audit programme, resources, activity reports and summary of recommendations and their implementation.
- 3.275. In order to permit a review of the effectiveness of the work of the internal audit function, audits should be documented in a way that makes it possible to retrace the audit procedures undertaken and the findings these produced.

CEIOPS' advice

- 3.276. To ensure its independence from the organisational activities audited, the internal audit function shall carry out its assignments with impartiality. The internal audit function shall be able to exercise its assignments on its own initiative in all areas of the undertaking. It shall be free to express its opinions and to disclose its findings and its appraisals to the whole administrative, management or supervisory body.
- 3.277. The internal audit function shall have the complete and unrestricted right to obtain information, which includes the prompt provision of all necessary

information, the availability of all essential documentation and the ability to look into all activities and processes of the undertaking, relevant for the discharge of its responsibilities, as required in the performance of its tasks, as well as having direct communication with any member of the undertaking's staff.

- 3.278. To ensure the effectiveness of the internal audit function, every activity and every unit of the undertaking shall fall within its scope. The function shall draw up an audit plan to determine its future auditing actions, taking a risk-based approach in deciding its priorities.
- 3.279. The internal audit function shall at least annually produce a written report on its findings to be submitted to the administrative, management or supervisory body. The report shall cover 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 shall include recommendations on how to remedy inadequacies and also specifically address how past points of criticism and past recommendations have been implemented.

3.6. Actuarial Function

Explanatory text

- 3.280. The actuarial function as envisaged in Article 48(1) of the Level 1 text is not shaped on the position of the Responsible Actuary which has been introduced in a number of Member States. Nevertheless CEIOPS understands the establishment of an actuarial function to have been prescribed as a measure of quality assurance with a view to safeguarding that certain important decisions of undertakings can be taken based on expert technical actuarial advice²³.
- 3.281. Under Article 48(2) of the Level 1 text, it is incumbent upon the undertaking to make sure that persons charged with actuarial tasks have the relevant qualifications, experience and knowledge of applicable standards. CEIOPS does not envisage a specific university degree or training as a prerequisite for adequately fulfilling the actuarial function; in particular a person carrying out the relevant tasks does not need to acquire the occupational title of "actuary" in jurisdictions where such a title is available. The actuarial function requires an understanding of the stochastic nature of insurance and the risks inherent in assets and liabilities, including the risk of a mismatch between assets and liabilities, as well as an understanding of the use of statistical models.
- 3.282. As the actuarial function does not exist in other Directives, CEIOPS' proposals for this topic are subject to an impact assessment. For that reason, this section is laid out differently. It explains the issues identified by the Commission that were subject to impact assessment and describes CEIOPS' preferred option for each issue. Annex B of this Advice also sets out in greater detail the issues and options

²³ CEIOPS may develop Level 3 guidance on how any appointed actuary interacts with the responsibilities of the Actuarial Function.

considered and how they satisfy the objectives for the Solvency II framework set by the Commission.

- 3.283. The first issue identified by the Commission was about the standards to be applied by the actuarial function in exercising its tasks.
- 3.284. The vast majority of the actuarial profession is currently organised in national and international associations that may issue guidelines or set standards on technical, professional and ethical issues. These guidelines apply only to their own members.
- 3.285. CEIOPS understands that those associations have legitimacy and expertise to develop such guidelines and, in the case of standard setters of some Member States, to ensure compliance (and act accordingly in the case of non-compliance). As the methodologies and practices from actuarial professional bodies are widely accepted, these can generally be regarded as appropriate for supervisory purposes. However, there is a need to develop European actuarial guidelines for the purpose of ensuring a convergent implementation of Solvency II and a harmonised performance of the actuarial function.
- 3.286. Under the Solvency II regime, CEIOPS envisages a high level of convergence in the guidelines to be used, which is not compatible with the use of guidelines issued by national or international actuarial associations that are effective only for their own members. Consequently, some of these guidelines may be transformed in technical standards, guidance and/or recommendations.
- 3.287. The development and endorsement of such guidelines should ensure that the following three main principles are accomplished:
- a) The European actuarial guidelines are developed by highly qualified and experienced persons;
 - b) CEIOPS is able to express its views and concerns in relation to the guidelines being developed and to ultimately decide what technical standards, guidance and/or recommendations shall be issued at Level 3;
 - c) The technical standards, guidance or recommendations apply to all persons responsible for the actuarial function.
- 3.288. To ensure the accomplishment of these principles the following ideas are proposed:
- a) For the purpose of ensuring a convergent implementation of Solvency II and a harmonised performance of the actuarial function, European actuarial guidelines shall be developed. CEIOPS shall issue such European actuarial guidelines with respect to the actuarial methodologies and techniques to be used in determining technical provisions. These shall at least focus on the issues that are necessary for supervisory purposes;
 - b) The process of developing the above referred European actuarial guidelines shall be transparent and include the approval/endorsement by CEIOPS of the guidelines developed by the relevant expert groups and professional

bodies, following a period of public consultation;

- c) The process of developing the European actuarial guidelines shall involve participants with appropriate knowledge and experience of actuarial issues and should represent in balanced proportions the insurance industry, the actuarial profession and the academic community.
- 3.289. In Member States where a standard setter body of actuarial standards exists, this should be involved in the process, as it may be considered a body from the actuarial profession.
- 3.290. The endorsement by CEIOPS of technical actuarial standards, guidance and/or recommendations would not have an impact on the applicability of the local actuarial standards, that would still be applicable to the members of each association (except where the local guidelines are in contradiction with those endorsed by CEIOPS; in such cases, the latter should prevail in the context of the duties of the actuarial function). The actuarial associations should make all efforts to avoid any potential conflicts between existing guidelines. In case any conflicts exist, CEIOPS' technical standards, guidance and/or recommendations should prevail over the others.
- 3.291. Local standards on issues not covered by the actuarial provisions endorsed by CEIOPS could be applied by the persons performing the actuarial function to the extent that they are compatible with the Level 1 principles, Level 2 implementing measures and Level 3 technical standards, guidance and/or recommendations of Solvency II.
- 3.292. While feedback from consultation on this, regarding the three options considered under CEIOPS' Consultation Paper no. 33 on the System of Governance, was split between the ease of adopting existing technical standards, which might be inconsistent across countries, and the alternative of developing with stakeholders and ratifying specific technical standards, CEIOPS believes that further discussion on the detail is needed and therefore advises only on the high-level principles of the process. Further details leading to that view are set out in Annex B (Impact Assessment of Actuarial function).
- 3.293. The second issue identified by the Commission is related to scope of the tasks to be undertaken by the actuarial function.
- 3.294. CEIOPS considers the list of tasks set out in Article 48(1) to be comprehensive as far as mandatory tasks are concerned. To undertake these tasks, the actuarial function shall have access to the appropriate information systems that provide all necessary information, relevant for the discharge of its responsibilities.
- 3.295. That list of tasks does not, however, preclude the allocation of further duties to the actuarial function as the administrative, management or supervisory body sees fit, provided this does not compromise the proper segregation of duties within the undertaking.
- 3.296. Leaving the decision on the scope of the tasks to the undertakings would give greater flexibility for them in organising responsibilities and tailoring actuarial input to what they consider their individual needs. However, CEIOPS is concerned that not prescribing to some extent what is required in fulfilling the

tasks listed in Article 48(1) could erode the intention of the Level 1 text to provide a certain level of expert technical advice through the actuarial function.

- 3.297. Thus CEIOPS believes that defining, although in a general manner, the scope of the actuarial function's tasks could lead to a higher level of consistency and an increase in the quality of assurance of the outputs of this function across the EU, and is more in line with the objectives set by the Commission. More detail is provided in Annex B.
- 3.298. Set out below is an explanation of the additional scope of the tasks that is a consequence of this decision.
- 3.299. Article 48(1)(a) requires the actuarial function to coordinate the calculation of the technical provisions. In order to accomplish this task it should, at least:
- a) Apply methodologies and procedures to assess the sufficiency of technical provisions ensuring that their calculation is consistent with the underlying principles;
 - b) Assess the uncertainty associated with the estimates;
 - c) Produce judgement whenever this is needed, making use of appropriate information and experience of the persons that are in charge of the function;
 - d) Ensure that problems related to the calculation of technical provisions arising from insufficient data quality are dealt with appropriately and that, where it is impracticable to apply common methods of calculating technical provisions because of insufficient data quality, the most appropriate alternatives to common methods applied are found, taking into consideration the principle of proportionality;
 - e) Ensure that homogeneous risk groups for an appropriate assessment of the underlying risks are identified;
 - f) Consult any relevant market information and ensure that it is integrated into the assessment of technical provisions;
 - g) Compare and justify any material differences among the estimates for different years; and
 - h) Ensure that an appropriate assessment of options and guarantees embedded in liabilities is provided.
- 3.300. In relation to Article 48(1)(b), in order to ensure the appropriateness of the underlying methodologies and models, the actuarial function not only has to assess the general suitability of the methodology or underlying model for the calculation of technical provisions as such, but also has to decide whether they are appropriate for the specific lines of business of the undertaking, for the way the business is managed and for the available data.
- 3.301. While assessing the sufficiency and quality of the data under Article 48(1)(c), the actuarial function should have regard to the objectivity, reasonability and verifiability of management actions included in the calculation of technical

provisions. It should also assess whether information technology systems used in actuarial procedures sufficiently support these procedures. However, data auditing is a task that should be performed not by the actuarial function but by the internal audit function.

- 3.302. The comparison of the best estimates against experience under Article 48(1)(d) requires the actuarial function to assess whether past best estimates have proved sufficient and to use the insights gained in this assessment to improve the quality of present best estimate calculations.
- 3.303. This analysis should also include comparisons between observed values and the assumptions used in the calculation of technical provisions in order to produce conclusions on the appropriateness of the data used and the methodologies applied on their estimation.
- 3.304. The results of these comparisons should be reported to the administrative, management or supervisory body, given their relevance for the comprehension of the calculations performed and to support future decisions regarding this issue. It should be noted that these comparisons may be a practice not only of the actuarial function but also of the risk management function, and its area of application may be extended.
- 3.305. Article 48(1)(e) covers informing the administrative, management or supervisory body of the reliability and adequacy of the calculation of the technical provisions. This is not limited to expressing an opinion on these points but would include the degree of uncertainty about the ultimate outcome and the circumstances that might lead to a significant deviation from the provisions made. The actuarial function must also set out how it arrived at its opinion and clearly state and explain any concerns it may have as to the technical provisions being sufficient.
- 3.306. The reliability of the calculation of the technical provisions depends on adequate and good quality data. Therefore, the assessment of the sufficiency and quality of the data used in the calculation is information that needs to be included when the administrative, management or supervisory body is informed of the reliability and adequacy of the calculation.
- 3.307. The actuarial function should also assess the level of appropriateness, accuracy and completeness of the available data and convey recommendations on improving data quality, where appropriate. It may consider there is a need to introduce adjustments to the historical data, not because the data per se is considered inappropriate, but because it could be necessary to increase the level of its appropriateness for the purpose of the application of specific methodologies.
- 3.308. In this context the actuarial function should provide judgement as to how much credibility should be assigned to historical data and to prospective assumptions. This judgement has to be based notably on a careful analysis of the underlying liabilities, relevant market data, the undertaking's experience, especially with the portfolio concerned, and relevant qualitative information.
- 3.309. Reporting on the reliability of the technical provisions also includes informing the administrative, management or supervisory body on the results of comparisons

of the best estimates against experience and comments on the appropriateness of methodologies, underlying models and assumptions used.

- 3.310. Since the administrative, management or supervisory body is ultimately responsible for the reliable and adequate calculation of the technical provisions, the report must cover all information the administrative, management or supervisory body needs to form its own opinion on the issue.
- 3.311. In the scope of the coordination of the calculation of technical provisions, the actuarial function should, as under Article 48(1)(f), oversee when a case-by-case approach should be followed, that is, when there is not sufficient quality of data to apply a reliable actuarial method. Also, it has to produce judgement to establish assumptions and to safeguard the accuracy of the results.
- 3.312. In relation to Article 48(1)(g) and (h), the actuarial function shall annually express an opinion on the overall underwriting policy and the adequacy of the significant reinsurance arrangements, as well as expected cover under stress scenarios and report these views to the administrative, management or supervisory body and senior management. In the provision of these opinions the actuarial function shall not only address possible deficiencies and the possible consequences these may have, but also make constructive suggestions for improvements.
- 3.313. In CEIOPS' view the requirement on the actuarial function to express an opinion on the overall underwriting policy and the adequacy of the reinsurance arrangements does not imply that the actuarial function may not be involved in the original decisions on these issues. However, "justification" of decisions taken by the actuarial function or with its involvement requires more detailed explanations and a decided examination of other possible decision options.
- 3.314. Commenting on the overall underwriting policy does not require expressing views on every single policy, but 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.
- 3.315. Regarding the overall underwriting policy, the opinion to be expressed by the actuarial function should at least include the following issues:
 - a) Analysis of the sufficiency of the premiums²⁴ to cover future losses, notably taking into consideration the underlying risks, the impact of expenses directly associated with future claims and of unallocated loss adjustment expenses and the impact of embedded options and guarantees on future liabilities; and
 - b) Considerations regarding inflation, legal risk, change of mix, anti-selection and adequacy of *bonus-malus* system(s) implemented in specific line(s) of business.

²⁴ CEIOPS believes that the actuarial function should be aware if the undertaking is underwriting at a loss, for example, and the consequences of doing so.

- 3.316. Regarding the overall reinsurance arrangements, the opinion to be expressed by the actuarial function should include an opinion on the adequacy of the reinsurance and other mitigation techniques strategy in relation to the underwriting policy and the adequacy of the calculation of the technical provisions arising from reinsurance.
- 3.317. In forming and formulating its own actuarial view the actuarial function shall be objective and free from influence of other functions or the administrative, management or supervisory body and provide its opinions in an independent fashion.
- 3.318. The third specific issue which the Commission identified was the reporting of the actuarial function.
- 3.319. As a minimum requirement CEIOPS was clear that the actuarial function shall at least annually produce written reports to be submitted to the administrative, management or supervisory body on the mandatory tasks performed. That document should set out the steps that have been undertaken, clearly state any shortcomings identified and give recommendations as to how the deficiencies could be remedied. The reports should document the decisions to be taken in view of the findings and recommendations of the actuarial function. The issue particularly focussed around whether the structure of this report should be set out at Level 2, or left to undertakings.
- 3.320. While setting structures at Level 2 potentially achieves greater consistency in approach, it has the disadvantage of being less flexible to the circumstances of the undertaking. This is particularly important as the primary audience of the report is the management of the undertaking, although the supervisory authority may request the actuarial report on an ad hoc basis.
- 3.321. Thus CEIOPS considers the option of defining the structure and content of the report in Level 2 to be excessive and that the actuarial function's report should reflect the specificities of the undertaking and take into account the principle of proportionality. Also, as CEIOPS does not intend to define the structure and content of any report of the system of governance, it does not envisage a reason for doing so in the case of the actuarial function. In Annex B more explanation of the rationale is included.
- 3.322. Detailed monitoring should be undertaken regarding the measures implemented by the undertaking in the pursuit of the actuarial recommendations.
- 3.323. Article 44(5) sets out that the risk management function is responsible for a number of areas of the internal model. This aims to ensure that the model is seen as a widely-understood risk management tool within the business and not purely a mathematical model. Despite the fact that the risk management function is responsible for the design, implementation, testing and validation of the internal model this does not preclude the actuarial function from assisting in these tasks. As set out in Article 48(1)(i) the actuarial function is in particular required to contribute to the risk modelling underlying the calculation of the capital requirement. Depending on the complexity of the risk management system, actuarial methods need to be applied that call for a detailed understanding of statistical methods and the probabilities of insurance risks, such as mortality, morbidity, claims frequencies and severities, understanding and assessing the

- use of risk mitigation techniques and understanding volatility and adverse deviation.
- 3.324. An effective risk management system requires input from the actuarial function (e.g. in the quantification and modelling of risks). This is not limited to a contribution to the ORSA or an internal model, if any, but includes also an involvement in e.g. asset-liability management, and risk mitigation arrangements.
- 3.325. The fact that the actuarial function shall “contribute to the effective implementation of the risk management system”, and that according to Article 44(4) the risk management function shall facilitate the implementation of the risk management system, does not imply that both functions should be organised as different organisational units. A full or partial integration of these functions is acceptable.
- 3.326. As stated before, CEIOPS does not envisage a specific university degree or training as a prerequisite for adequately fulfilling the actuarial function; in particular a person carrying out the relevant tasks does not need to acquire the occupational title of “actuary” in jurisdictions where such a title is available. The actuarial function requires an understanding of the stochastic nature of insurance and the risks inherent in assets and liabilities, including the risk of a mismatch between assets and liabilities, as well as an understanding of the use of statistical models.
- 3.327. In order to be considered sufficient, the level of knowledge should be commensurate with the sophistication of the methodologies and techniques appropriately employed by the undertaking. Undertakings which under a risk-based approach may use relatively simple calculation methods, do not have an internal model or a complex risk management system and rely on elementary reinsurance arrangements may require a comparatively lower level of knowledge in actuarial and financial mathematics in the person(s) carrying out the actuarial function. The undertaking shall be able to demonstrate to the supervisor that the applied methodologies and techniques are adequate having regard to the specificities of the undertaking.

CEIOPS’ advice

- 3.328. For the purpose of ensuring a convergent implementation of Solvency II and a harmonised performance of the actuarial function, European actuarial guidelines shall be developed. CEIOPS shall issue such European actuarial guidelines with respect to the actuarial methodologies and techniques to be used in determining technical provisions. These shall at least focus on the issues that are necessary for supervisory purposes.
- 3.329. The process of developing the above referred European actuarial guidelines shall be transparent and include the approval/endorsement by CEIOPS of the guidelines developed by the relevant expert groups and professional bodies, following a period of public consultation.
- 3.330. The process of developing the European actuarial guidelines shall involve

participants with appropriate knowledge and experience of actuarial issues and shall represent in balanced proportions the insurance industry, the actuarial profession and the academic community.

3.331. The actuarial function shall have access to the appropriate resources and information systems that provide all necessary information, relevant for the discharge of its responsibilities.

3.332. In coordinating the calculation of the technical provisions the actuarial function shall at a minimum:

- a) Apply methodologies and procedures to assess the sufficiency of technical provisions ensuring that their calculation is consistent with the underlying principles;
- b) Assess the uncertainty associated with the estimates;
- c) Produce judgement whenever this is needed, making use of appropriate information and experience of the persons that are in charge of the function;
- d) Ensure that problems related to the calculation of technical provisions arising from insufficient data quality are dealt with appropriately and that, where it is impracticable to apply common methods of calculating technical provisions because of insufficient data quality, the most appropriate alternatives to common methods are found, taking into consideration the principle of proportionality;
- e) Ensure that homogeneous risk groups for an appropriate assessment of the underlying risks are identified;
- f) Consult relevant market information and ensure that it is integrated into the assessment of technical provisions;
- g) Compare and justify any material differences among the estimates for different years; and
- h) Ensure that an appropriate assessment of options and guarantees embedded in liabilities is provided.

3.333. In order to ensure the appropriateness of the underlying methodologies and models used in the calculation of the technical provisions, the actuarial function not only has to assess the general suitability of the methodology or underlying model for the calculation of technical provisions as such, but also has to decide whether they are appropriate for the specific lines of business of the undertaking, for the way the business is managed and for the available data.

3.334. While assessing the sufficiency and quality of the data used in the calculation of the technical provisions, the actuarial function shall have regard to the objectivity, reasonability and verifiability of management actions included in the calculation of technical provisions. It shall also assess whether information technology systems used in actuarial procedures sufficiently support these procedures.

- 3.335. The comparison of the best estimates against experience requires the actuarial function to assess whether past best estimates have proved sufficient and to use the insights gained in this assessment to improve the quality of present best estimate calculations.
- 3.336. This analysis shall also include comparisons between observed values and the assumptions used in the calculation of technical provisions in order to produce conclusions on the appropriateness of the data used and the methodologies applied on their estimation.
- 3.337. Informing the administrative, management or supervisory body of the reliability and adequacy of the calculation of the technical provisions is not limited to expressing an opinion on these points, including on the degree of uncertainty about the ultimate outcome and the circumstances that might lead to a significant deviation from the provisions made. The actuarial function must set out how it arrived at its opinion and clearly state and explain any concerns it may have as to the technical provisions being sufficient.
- 3.338. The actuarial function shall oversee when a case-by-case approach to the calculation of technical provisions shall be followed, that is, when there is not sufficient quality of data to apply a reliable actuarial method. Also, it has to produce judgement to establish assumptions and to safeguard the accuracy of the results.
- 3.339. Regarding the overall underwriting policy, the opinion to be expressed by the actuarial function shall at least include the following issues:
- a) Sufficiency of the premiums to cover future losses, notably taking into consideration the underlying risks (including underwriting risks), the impact of expenses directly associated with future claims and of unallocated loss adjustment expenses and the impact of embedded options and guarantees on future liabilities; and
 - b) Considerations regarding inflation, legal risk, change of mix, anti-selection and adequacy of *bonus-malus* system(s) implemented in specific line(s) of business.
- 3.340. Regarding the overall reinsurance arrangements, the opinion to be expressed by the actuarial function shall include an opinion on the adequacy of the significant reinsurance arrangements as well as expected cover under stress scenarios in relation to the underwriting policy and the adequacy of the calculation of the technical provisions arising from reinsurance.
- 3.341. In order to be able to provide its opinions free from influence from other functions and the administrative, management or supervisory body, the actuarial function shall be constituted by persons who have a sufficient level of independency.
- 3.342. In forming and formulating its own actuarial view the actuarial function shall be objective and free from influence of other functions and the administrative, management or supervisory body.
- 3.343. The actuarial function shall at least annually produce written reports to be

submitted to the administrative, management or supervisory body. The reports shall document the tasks that have been undertaken, clearly state any shortcomings identified and give recommendations as to how the deficiencies could be remedied.

3.7. Outsourcing

Explanatory text

3.344. Article 49(1) of the Level 1 text states:

Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.

- 3.345. Outsourcing in the context of the Level 1 text means an arrangement of any form between an insurance or reinsurance undertaking and a service provider, whether a supervised entity or not, by which that service provider performs a process, a service or an activity, whether directly or by sub-outsourcing, which would otherwise be performed by the insurance or reinsurance undertaking by itself.
- 3.346. A service provider may be a supervised entity, it may be an entity from the same group as the undertaking (internal outsourcing) or not and it may be located inside the EU as well as outside.
- 3.347. In principle all functions and activities of a (re)insurance undertaking can be outsourced provided its administrative, management or supervisory body retains ultimate responsibility for discharging its obligations.
- 3.348. Outsourcing does not prevent an undertaking from giving guidelines or instructions in individual cases as to how the outsourcing is to be performed.
- 3.349. Not every provision of a function or service to an undertaking by a service provider will fall within the meaning of outsourcing above. Hiring a specialist consultant to provide one-off technical advice does not constitute outsourcing, though it may become so if the undertaking subsequently relies on that consultant to manage an internal function or service, e.g. when it is installed or becomes fully operational. CEIOPS would expect to elaborate further on what might or might not constitute outsourcing in Level 3 guidance.
- 3.350. The undertaking should develop a written policy regarding outsourcing which should be approved by the administrative, management or supervisory body.
- 3.351. The undertaking's outsourcing policy should include considerations of the impact of outsourcing on its business and the reporting and monitoring arrangements to be implemented when an outsourcing contract has been agreed. The policy should be regularly assessed and updated, with any necessary changes implemented.

3.352. As the undertaking remains fully responsible for all outsourced functions and activities it needs to include in its risk management systems and controls 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.

3.353. Article 49(2) of the Level 1 text states:

Outsourcing of critical or important operational functions or activities shall not be undertaken in such a way as to lead to any of the following:

(a) materially impairing the quality of the system of governance of the undertaking concerned;

(b) unduly increasing the operational risk;

(c) impairing the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations;

(d) undermining continuous and satisfactory service to policy holders.

3.354. CEIOPS believes that critical or important functions with regard to the provisions of the Level 1 text include the key functions of an undertaking's system of governance and all functions within the undertaking that are fundamental to carry out its core business, e.g. design, pricing and design of insurance products, investment of assets, portfolio management or claims handling.

3.355. The provision by a third party of functions such as legal opinions or specialised training is not considered by CEIOPS as critical or important for the purposes of the Level 1 text. This is because, even if they could be considered outsourcing under certain specific circumstances, they do not form part of an undertaking's core business.

3.356. When choosing a service provider for any critical or important functions or activities the undertaking has to carry out all necessary steps to see that:

a) A detailed examination is performed of the potential service providers' ability and capacity to deliver the required functions or activities satisfactorily, taking into account the undertaking's objectives and needs;

b) The service provider has adopted all means to ensure that no explicit or potential conflicts of interest with the undertaking impair the needs of the outsourcing undertaking;

c) It enters into a written agreement with the service provider which clearly allocates the respective rights and obligations of the undertaking and the service provider;

d) The general terms and conditions of the outsourcing agreement are authorised and understood by the undertaking's administrative,

management or supervisory body;

- e) The outsourcing does not represent a breach of any data protection regulation or any other laws; and
 - f) The service provider is subject to the same provisions that are applicable to the undertaking regarding the safety and the confidentiality of the information related to its clients.
- 3.357. The examination to be performed should allow the undertaking to understand the main risks that might arise from the outsourcing identify the most suitable strategies for the mitigation/management of these risks and 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 should be documented and reviewed by the undertaking at any time it is considered relevant.
- 3.358. It is the responsibility of the undertaking to ensure that the terms of the outsourcing agreement are consistent with the undertaking's obligations under the Level 1 text. The written agreement to be concluded between the undertaking and the service provider should in particular clearly state the following requirements:
- a) The duties and responsibilities of both parties involved;
 - b) The service provider's commitment to comply with all applicable laws, regulatory requirements and guidelines and to cooperate with the undertaking's supervisors in connection with the outsourced function or activity;
 - c) The service provider discloses any developments that may have a material impact on its ability to carry out the outsourcing, including any adverse effect from new laws or regulations introduced in its home country and any material changes to its financial resources or its risk profile;
 - d) That the service provider can only terminate the contract with a period sufficiently long to enable the undertaking to find an alternative solution;
 - e) That the undertaking has the right to terminate the arrangement for the outsourcing with a reasonable period of notice if for any reason the services rendered should prove to be inadequate;
 - f) That the undertaking reserves the right to information about the outsourced activities and the service provider's performance of the outsourcing as well as a right to issue general guidelines and individual instructions as to what is to be taken into account when performing the outsourced functions or activities;
 - g) That the service provider shall protect any confidential information relating to the undertaking and its clients;
 - h) That the undertaking, its external auditor and the supervisory authority competent for its supervision will have effective access to all information related to the outsourced functions or activities, as well as to the service

provider's business premises if an on-site inspection or audit is to be performed; and

- i) That the supervisory authority has the right to directly address questions to the service provider.
- 3.359. If the service provider is located outside the Member State of the undertaking, the written agreement to be established should also include provisions on the resolution of any disputes between the undertaking and the service provider, namely regarding the jurisdiction that proceedings are subject to.
- 3.360. The outsourcing agreement should also determine whether sub-outsourcing is possible. If this is the case, the agreement between the service provider and the sub-service provider(s) needs to regulate the conditions which apply and must not affect the service provider's responsibilities under the outsourcing agreement with the undertaking. Generally the service provider must ensure the quality of the sub-service provider in the same way the undertaking is to make sure the service provider is able to render satisfactory services. The undertaking also has to maintain the rights and powers of the supervisory authority and its auditors with regard to the sub-outsourced activities. The undertaking remains responsible for ensuring the outsourced activity is satisfactorily performed, including the terms of the sub-outsourcing contract.
- 3.361. The ownership of any intellectual work rendered by the service provider, e.g. in the case of software development, should be made clear in the outsourcing agreement, both in case of cancellation or contract expiration.
- 3.362. Irrespective of the service provider's risk management obligation to establish suitable contingency plans, the undertaking needs to consider in its own contingency planning the possibility of having to face an emergency situation or business disruption arising from a failure or a problem of the service provider.
- 3.363. In case of internal outsourcing, i.e. where the service provider is in the same group as the undertaking, some of the requirements may be applied more flexibly. The examination of the service provider may be less detailed provided the undertaking's administrative, management or supervisory body has greater familiarity with the service provider and if the undertaking has sufficient control over, or can influence the actions of, the service provider.
- 3.364. Internal outsourcing may potentially pose a lower level of risk to an undertaking but it is unlikely to pose no risk at all. Hence the undertaking should assess whether and to what extent it should rely on functions and activities provided. 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.
- 3.365. 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.

- 3.366. To ensure that the outsourcing of any critical or important functions or activities does not lead to a material impairment of the quality of the undertaking's governance system:
- a) The undertaking must ensure that the service provider has in place an adequate risk management and internal control system;
 - b) The outsourced activities must be adequately included in the undertaking's risk management and internal control system; and
 - c) The undertaking must establish a contractual right to information about the outsourced activities and a contractual right to issue instructions concerning the outsourced activities.
- 3.367. In order to ensure against an undue increase in operational risk, when outsourcing critical or important functions or activities the outsourcing undertaking should:
- a) Verify that the service provider has adequate financial resources to take on the additional tasks the undertaking plans to transfer and to properly and reliably discharge its duties towards the undertaking and that the staff of the service provider is chosen on the basis of criteria that give reasonable assurance that they are sufficiently qualified and reliable;
 - b) Verify that the service provider properly isolates and identifies the information, documentation and assets belonging to the undertaking and its clients in order to protect their confidentiality; and
 - c) Make sure the service provider has adequate contingency plans in place to deal with emergency situations or business disruptions and has periodic testing of backup facilities where that is necessary having regard to the function, service or activity outsourced.
- 3.368. In order to ensure that the outsourcing of critical or important functions or activities does not impair the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations under the Level 1 text, it must comply with Article 38 of the Level 1 text and must ensure:
- a) The service provider's cooperation with the supervisory authorities of the undertaking in connection with the outsourced functions or activities;
 - b) The undertaking, its auditors and the relevant supervisory authorities have effective access to data related to the outsourced functions or activities; and
 - c) The supervisory authorities have effective access to the business premises of the service provider and are able to exercise this right.
- 3.369. CEIOPS considers that a written agreement between an undertaking and its service provider, contained in the requirements set out in paragraph 3.358 b), h) and i), is all the undertaking can do to ensure compliance with Article 38

before the outsourcing²⁵. Such a written agreement will also ensure that, irrespective of whether or not a service provider is located in the EU, the undertaking's supervisory authorities will be able to assess the undertaking's compliance with its obligations.

3.370. As part of good management practice, CEIOPS expects an undertaking to effectively monitor whether its service provider is in compliance with all the terms of their written agreement. If the service provider does not carry out the functions or activities effectively and 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 should terminate the outsourcing agreement. In this, context, where a service provider is located outside the EU, undertakings should pay particular attention to whether the service provider's regulator and/or local laws and regulations might restrict access to information about the outsourced activity or function or to the service provider's premises.

3.371. Article 49(3) of the Level 1 text states:

Insurance and reinsurance undertakings shall, in a timely manner, notify the supervisory authorities prior to the outsourcing of critical or important functions or activities as well as of any subsequent material developments with respect to those functions or activities.

3.372. CEIOPS envisages that the critical or important activities which involve notification requirements in case of outsourcing will be identified consistently across the Member States when the Level 1 text is implemented into national law. It also expects supervisors to be endowed with the necessary powers to intervene if the outsourcing arrangements give rise to concerns about a possible non-compliance with Article 49 or Article 38(1)(b) or any of the conditions for outsourcing the Commission may adopt by way of implementing measures pursuant to Article 50(4).

3.373. Article 49(3) requires undertakings to notify supervisory authorities in a timely manner prior to the outsourcing of critical or important functions or activities. This does not necessarily mean that the supervisor has to approve or authorise the outsourcing. Rather the prior notification presents an opportunity for the supervisor to discuss concerns with the undertaking if the outsourcing appears not to comply with the provisions of the Directive and to object if supervisory concerns cannot be dispelled. Accordingly, CEIOPS interprets "in a timely manner" to constitute a period of time sufficient for the supervisor to examine the proposed outsourcing before it comes into force. This could be at least six weeks before the outsourcing is due to come into effect.

3.374. Subsequent material developments that entail further notification requirements are all developments that are relevant for supervisory purposes, i.e. any circumstances that may give supervisors reason to reassess the compliance with the Directive or implementing measure requirements or adversely affect the undertaking's ability to deliver its service to policyholders. This could in

²⁵ Once the outsourcing agreement is concluded ensuring that the "necessary steps" in terms of Article 38 are taken includes acting to enforce the right to access if this is denied regardless of the contractual obligation to give access.

particular apply to material changes in the outsourcing arrangements, a change of service provider or major problems with the performance of the service provider, such as e.g. non-performance on account of business disruption, non-compliance with applicable laws and regulations, serious and repeated infringements of guidelines, inadequate risk management, insufficient granting of access to data and information or anything else that causes significant dissatisfaction to the undertaking or policyholders about the service.

3.375. Taking into consideration the requirements that have to be met, particularly those in respect of the written agreement between an undertaking and its service provider, CEIOPS believes that these notification arrangements are suitably flexible and that different notification arrangements for service providers located inside the EU as opposed to outside the EU are not necessary.

CEIOPS' advice

3.376. The undertaking's outsourcing policy shall include considerations of the impact of outsourcing on its business and the reporting and monitoring arrangements to be implemented in case of outsourcing. The policy shall be regularly assessed and updated with any necessary changes implemented.

3.377. If an undertaking and the service provider are members of the same group, the undertaking the extent to which it controls the service provider or has the ability to influence its actions shall be taken into account.

3.378. Critical or important functions with regard to the provisions of the Level 1 text include the key functions of an undertaking's system of governance and all functions within the undertaking that are fundamental to carry out its core business.

3.379. When choosing a service provider for any critical or important functions or activities the undertaking shall undertake all necessary steps to ensure that:

- a) A detailed examination is performed of the potential service provider's ability and capacity to deliver the required functions or activities satisfactorily, taking into account the undertaking's objectives and needs;
- b) The service provider has adopted all means to ensure that no explicit or potential conflict of interests with the undertaking impairs the needs of the outsourcing undertaking;
- c) It enters into a written agreement with the service provider which clearly allocates the respective rights and obligations of the undertaking and the service provider;
- d) The general terms and conditions of the outsourcing agreement are authorised and understood by the undertaking's administrative, management or supervisory body;
- e) The outsourcing does not represent a breach of any data protection regulation or any other laws; and

- f) The service provider subjects to the same provisions that are applicable to the undertaking regarding the safety and the confidentiality of the information related to its clients.

3.380. It is the responsibility of the undertaking to ensure that the terms of the outsourcing agreement are consistent with the undertaking's obligations under the Level 1 text. The written agreement to be concluded between the undertaking and the service provider shall in particular clearly state the following requirements:

- a) The duties and responsibilities of both parties involved;
- b) The service provider's commitment to comply with all applicable laws, regulatory requirements and guidelines and to cooperate with the undertaking's supervisors in connection with the outsourced function or activity;
- c) The service provider discloses any developments that may have a material impact on its ability to carry out the outsourcing, including any adverse effect from new laws or regulations introduced in its home country and any material changes to its financial resources or its risk profile;
- d) That the service provider can only terminate the contract with a period sufficiently long to enable the undertaking to find an alternative solution;
- e) That the undertaking has the right to terminate the arrangement for the outsourcing with a reasonable period of notice if for any reason the services rendered shall prove to be inadequate;
- f) That the undertaking reserves the right to information about the outsourced activities and the service provider's performance of the outsourcing as well as a right to issue general guidelines and individual instructions as to what is to be taken into account when performing the outsourced functions or activities;
- g) That the service provider shall protect any confidential information relating to the undertaking and its clients;
- h) That the undertaking, its external auditor and the supervisory authority competent for its supervision will have effective access to all information related to the outsourced functions or activities, as well as to the service provider's business premises if an on-site inspection or audit is to be performed; and
- i) That the supervisory authority has the right to directly address questions to the service provider.

3.381. To ensure the outsourcing of any critical or important functions or activities does not lead to a material impairment of the quality of the undertaking's governance system:

- a) The undertaking must ensure that the service provider has in place an adequate risk management and internal control system;

- b) The outsourced activities must be adequately included in the undertaking's risk management and internal control system; and
- c) The undertaking must establish a contractual right to information about the outsourced activities and a contractual right to issue instructions concerning the outsourced activities.

3.382. In order to ensure against an undue increase of operational risk, when outsourcing critical or important functions or activities the outsourcing undertaking shall:

- a) Verify that the service provider has adequate financial resources to take on the additional tasks the undertaking plans to transfer and to properly and reliably perform its duties towards the undertaking and that the staff of the service provider is chosen on the basis of criteria that give reasonable assurance that they are sufficiently qualified and reliable;
- b) Verify that the service provider properly isolates and identifies the information, documentation and assets belonging to the undertaking and its clients in order to protect their confidentiality; and
- c) Make sure the service provider has adequate contingency plans in place to deal with emergency situations or business disruptions and has periodic testing of backup facilities where that is necessary having regard to the function, service or activity outsourced.

4. Annexes

Annex A: Main conclusions taken out from the QIS 4 OpRisk questionnaire

- 4.1. While developing the implementing measures to be applied in the context of the management of operational risk, CEIOPS has taken into account the main findings from the operational risk section of the QIS4 exercise, namely the ones on the qualitative questions, published in October 2008, which were:
- The average per country of the percentage of the **operational risk capital charge** to the total SCR ranged from 5% to 10%;
 - 47% of the respondents felt that the operational risk charge is **adequately designed**, while 53% of respondents thought it was not adequately designed;
 - One Member State responded that the operational risk charge as currently calibrated in the standard formula understates the operational risk requirement as set by the undertakings' own **internal model** sometimes by more than half;
 - In relation to the **formula**, respondents stated that:
 - The standard formula is too simplistic, since it is not risk sensitive, and rewards low pricing and reserving;
 - The consideration of 100% correlation with other risks is not appropriate;
 - The formula does not take into account the quality of the operational risk management processes of each undertaking, nor does it encourage the development of good risk management practices;
 - The maximum of 30% of the BSCR for the capital charge is considered too high;
 - The formula does not reflect the wide spectrum of operational risks that can materialise within an undertaking;
 - The main suggestions to **remedy the perceived deficiencies** in the standard formula were:
 - The operational risk charge should be calculated as a percentage of the BSCR or the SCR;
 - The operational risk charge should be more sensitive to operational risks management;
 - The operational risk charge should be based on the entity-specific operational risk sources and the quality of the operational risk management process and the internal control framework;

- Diversification benefits and risk mitigation techniques should be considered;
- Regarding the qualitative questions posed about operational risk management systems, the responses indicated that there is a **wide range of practices** currently followed by undertakings, with some indicating that they have stochastic modelling techniques to quantify capital requirements for operational risk and others had yet to even start collecting and categorising operational risk losses. For example, 39% of respondents stated that they capture operational risk loss events and most of these then attempt to quantify these loss events;
- Among the undertakings that categorise the operational risk events, the most **common categorisation** used is the one proposed by the Operational Risk Insurance Consortium (**ORIC**²⁶), which is based on the categorisation established by the Capital Requirements Directive (Basel II). A number of undertakings however stated that they used their own categorisation.

Annex B: Impact assessment – Actuarial function

Description of the policy issues

- 4.2. In its Call for Advice of 1 April 2009, the European Commission (“Commission”) asked CEIOPS to contribute to the Commission’s impact assessment of the Level 2 implementing measures²⁷. To this end, a list of issues has been set up by the Commission and CEIOPS, identifying the Level 2 implementing measures that should be accompanied by an impact assessment. The objectives of the issues have been selected among the list of objectives used by the Commission in its Level 1 impact assessment²⁸. On 12 June 2009, the Commission has issued an updated list of policy issues and options, to which reference is being made²⁹.
- 4.3. The present impact assessment covers Issue 16 (on the “Actuarial function”) of the list of policy issues and options, which CEIOPS has looked into in order to further clarify their detail. Summary tables, published in a separate excel document³⁰, accompany the impact assessment.
- 4.4. In considering the requirements arising under Article 48 of the Level 1 text, the operational objectives set out for the actuarial function under Solvency II by the

²⁶ The Operational Risk Insurance Consortium (ORIC) is a partnership established between the Association of British Insurers (ABI) and the software company SAS that intends to provide a high-quality database cataloguing operational risk loss events. ORIC members receive, on a quarterly basis, information on losses due to failed people, processes, systems or external events, by both monetary amount and narrative description. To feed the database, individual firms have to submit their own data on operational risk, with total anonymity.

²⁷ <http://www.ceiops.eu/media/files/requestsforadvice/EC-april-09-CfA/EC-call-for-advice-Solvency-II-Level-2.pdf>

²⁸ http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf

²⁹

<http://www.ceiops.eu/media/files/requestsforadvice/EC-June-09-CfA/Updated-List-of-policy-issues-and-options-for-IA.pdf>.

³⁰ See Impact assessment sheet <http://www.ceiops.eu/index.php?option=content&task=view&id=581>

Commission³¹ are to (references after the objectives refer to the chapter in the EC Impact Assessment Report):

- a) Introduce proportionate requirements for small undertakings (objective 3.3.4);
- b) Harmonise supervisory powers, methods and tools (objective 3.3.5);
- c) Promote compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA (objective 3.3.9); and
- d) Ensure efficient supervision of insurance groups and financial conglomerates (objective 3.3.10).

4.5. The impact assessment for the actuarial function covers three issues, for which a number of options have been considered. These options were considered by CEIOPS as it developed the advice contained within the main sections of this paper. The issues and options considered are:

Issue A. The standards to be applied by the function

- Option 1. The function should use technical standards developed by CEIOPS on Level 3.
- Option 2. The function should rely on technical standards that are widely accepted in the industry and the profession.
- Option 3. The function should rely on European technical standards to be developed and endorsed by a body of representatives of different stakeholders, including CEIOPS.

Issue B. The scope of the tasks of the actuarial function

- Option 1. It should be left to undertakings to decide on the scope of these tasks individually.
- Option 2. The general scope of the tasks should be prescribed on Level 2 to some extent.

Issue C. The reporting of the actuarial function

- Option 1. Require annual reporting with definition on Level 2 of its structure and content.
- Option 2. Require annual reporting but leave the decision on the details up to the undertakings.

Impact on industry, policyholders and beneficiaries and supervisory authorities

³¹ See Chapter 3 of the EC Impact Assessment Report at http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf.

Issue A. The standards to be applied by the function

- Option 1. The function should use technical standards developed by CEIOPS on Level 3.
- Option 2. The function should rely on technical standards that are widely accepted in the industry and the profession.
- Option 3. The function should rely on European technical standards to be developed and endorsed by a body of representatives of different stakeholders, including CEIOPS.

The analysis of the costs and benefits of the options took into consideration the fact that technical standards currently in use also need to be adapted to the new principles of the Solvency II regime.

Cost and benefits

- Policyholders and Beneficiaries

- 4.6. For policyholders, the impact of the options will be indirect. By having defined actuarial standards, undertakings will indirectly better be able to deliver the benefits expected by policyholders. The consequence if this is not done is potentially lower protection of policyholders. Also, depending on which standards are adopted, the costs of implementation might be higher, indirectly impacting policyholders as costs get passed on. The impact is unlikely to be the same in all Member States as it will depend on existing actuarial standards..
- 4.7. Option 1 would ensure a level playing field across Europe and a high level of involvement of CEIOPS. Depending on which standards are adopted, the costs of implementation would indirectly impact policyholders as costs get passed on. The level of protection of policyholders would be ensured by an appropriate set of guidelines.
- 4.8. Option 2 would have no involvement from CEIOPS and could ultimately have to be complemented by additional standards not initially foreseen. This option does not ensure a level playing field across Europe, namely regarding a harmonised level of protection of policyholders. Depending on which standards are amended/developed as a result of the principles adopted by Solvency II, the costs of implementation would, as for Option 1, indirectly impact policyholders as costs get passed on.
- 4.9. Option 3 is likely to result in the technical standards being based on best practice across Member States. As such, it is likely to result in an overall increase in the quality of the technical standards, which must be of indirect benefit to policyholders. An adequate level of involvement of CEIOPS and other stakeholders would allow an adequate set of guidelines and thus adequate protection of policyholders. Depending on which standards are adopted, the costs of implementation would indirectly impact policyholders as costs get

passed on, as in the case of the other options.

- Industry/(re)insurance undertakings

- 4.10. Option 1 would ensure a level playing field across Europe and a high level of involvement of CEIOPS. On the other hand, there could be the risk of not having specificities fully recognised. It is not expected that the costs of implementation differ much between different options from the undertakings' point of view. An appropriate set of guidelines would ensure that undertakings apply proper methodologies and a proper risk management by allowing an adequate level of actuarial information.
- 4.11. With Option 2, the level playing field across Europe is not ensured. This option would give more flexibility to the undertaking, since the guidelines wouldn't be mandatory. However, it is not expected that the costs of implementation would differ much as compared to the other options from the undertakings' point of view, since a proper implementation of the actuarial function is mandatory according to the Level 1 Directive.
- 4.12. The development of technical standards in line with Option 3 is likely to result in a set of guidelines, based on best practice across the Member States, that take into account the specificities of products and markets (as representatives of the industry would be involved in the process). As such, it is likely to result in an overall increase in the quality of the technical standards, and would ensure a level playing field across Europe and a high level of involvement of CEIOPS. It is not expected that the costs of implementation differ much between different options from the undertakings' point of view.

- Supervisory authorities

- 4.13. For the supervisory authorities, it is not clear that there is any practical difference between the options, at least in terms of their overheads. Irrespective of which option is adopted, supervisory authorities are likely to incur some costs in assessing whether undertakings are adhering to the standards set, but this is only expected to be when there are concerns raised. In the particular case of Option 1 there would be an indirect cost associated to the need of supervisory authorities having to finance the additional resources required by CEIOPS.
- 4.14. With Options 1 and 3, the technical standards will be clearly defined and understood, but Option 2 may lead to higher costs (than the other options) as there will be the scope for greater interpretation and discussion about what the industry and professional technical standards are, because they may not be codified.

Comparison and ranking of the policy options based on the efficiency and effectiveness of each option in reaching the relevant operational objectives

- 4.15. In terms of introducing proportionate requirements for small undertakings, option 2 is likely to be the most effective and efficient way of achieving that as it leaves the technical standards as they are, subject to the changes required by Solvency II; options 1 and 3 are slightly less effective or efficient, requiring

- undertakings to re-assess what is appropriate for their business.
- 4.16. However, in terms of harmonising supervisory powers, methods and tools, Option 2 is the least effective way of achieving that, although it is moderately efficient in terms of delivering harmonisation in a single Member State. Most effective in delivering harmonisation across Member States are Options 1 and 3, with the only difference likely to be in the level of involvement of CEIOPS and the detail of the technical standards. As Option 3 is likely to be the more comprehensive and reflect best practice in the industry and the profession, it will be marginally more effective. In terms of efficiency in delivering harmonisation, there is little to choose between Options 1 and 3.
- 4.17. The third operational objective of promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA is regarded very much as a by-product of this, rather than necessarily a driver. What is clear is that Option 2 is least effective, or efficient, in leading to any harmonisation with international bodies. Both Options 1 and 3 are more effective in achieving that, with Option 1 perhaps marginally more effective because it would be CEIOPS alone developing the standards (although these would obviously be subject to consultation with stakeholders at Level 3), rather than the combination of stakeholders and CEIOPS as would be the case with Option 3. However, this latter option is seen as a more efficient way of achieving this as stakeholders are brought actively into the process.
- 4.18. When considering the rankings of the options against the operational objective of ensuring efficient supervision of groups and financial conglomerates, the focus has to be more on cross-border groups. Clearly, Option 2 is the least effective and efficient in achieving that, although it would be good for groups that operate in only one jurisdiction. There is little to choose between Options 1 and 3, in terms of both effectiveness and efficiency, in best meeting this operational objective.
- 4.19. In terms of sustainability, Option 3 is considered the most sustainable as it is most likely to encompass best practice across Member States. This would be followed by Option 1, which is likely to require some changes in the light of practical experience, with Option 2 the least sustainable. In terms of consistency, Options 1 and 3 score equally, with Option 2 being the least consistent across Member States.
- 4.20. Overall, CEIOPS considers that Option 3 best meets the various operational objectives, actively involves stakeholders and is likely to be the best way of adopting best practice across Member States.
- 4.21. However, how option 3 would operate in practice is not totally clear yet. In the light of the feedback received to the consultation paper and discussions held, CEIOPS considers that further discussion on the detail is needed and therefore the advice is only on the high-level principles of the process.

Issue B. The scope of the tasks of the actuarial function

- Option 1. It should be left to undertakings to decide on the scope of these tasks individually.
- Option 2. The general scope of the tasks should be prescribed on Level 2 to some extent.

Cost and benefits

- Policyholders and Beneficiaries

- 4.22. Once again, the impact on policyholders is likely to be indirect, and be a consequence of the tasks undertaken by the actuarial function not being sufficiently detailed for the administrative, management or supervisory body to base its decisions on. In such circumstances, there will be a risk to policyholders that either premiums will rise or benefits may be reduced and their protection diminished, but the actual costs incurred by the industry are expected to be minimal.
- 4.23. Option 1 would give the undertaking a degree of flexibility within the parameters set at Level 1. While this may reflect little change from existing practice, it does set a standard, and this may expose some policyholders to an indirect risk.
- 4.24. Option 2 on the other hand would define the general scope of the tasks, while keeping some flexibility, and should reduce the risks to policyholders of higher premiums or reduced benefits.

- Industry/(re)insurance undertakings

- 4.25. Option 1 would allow undertakings to determine the scope of the tasks themselves. While this may allow them to better control their direct costs, it may mean that the administrative, management or supervisory body does not receive the quality of advice from the actuarial function that is desired. So, while Option 1 might have less impact on direct costs, it may lead to a negative indirect impact on the quality of management decisions.
- 4.26. Option 2 on the other hand would ensure that the administrative, management or supervisory body would have at least a certain predefined level of information on which to base its decisions. This may mean that direct costs are higher than would otherwise be the case, but management decisions should be more informed as a result.

- Supervisory authorities

- 4.27. From a supervisory perspective, Option 1 would mean that supervisors are more likely to have to use resources to review the scope of the tasks undertaken by the actuarial function to assess the input to the management function, and react according to the findings of such reviews.

- 4.28. By setting the general scope of the tasks as proposed in Option 2, supervisors should be able to take greater comfort that the actuarial function is actually performing as intended, so in depth reviews of that should be needed less frequently, leading to a lower level of overheads compared with Option 1.

Comparison and ranking of the policy options based on the efficiency and effectiveness of each option in reaching the relevant operational objectives

- 4.29. Option 1 is more effective than option 2 in delivering proportionate requirements by not defining the scope of the tasks, but Option 2 is probably more efficient in achieving it. With either option however, the tasks would only be undertaken to a depth appropriate for the business, according to the principle of proportionality that underlies all Solvency II governance requirements.
- 4.30. In terms of introducing harmonised supervisory powers, methods and tools, Option 2 better meets that objective by defining the general scope of the tasks. By defining only the general scope, it leaves some degree of flexibility to the undertaking to define the scope in more detail. While Option 1 still has Level 1 text behind it giving harmonisation in the mandatory tasks, it does not harmonise the scope of the tasks, even at a minimum level.
- 4.31. Option 2 clearly meets the operational objective of promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA more effectively and efficiently because there would be a minimum prescribed scope. However, it should be noted that IAIS and IAA have no such standards at present, so there is not guarantee that this will be compatible with their eventual work. Option 1 is neither efficient or effective in this regard.
- 4.32. Turning to the objective of ensuring efficient supervision of insurance groups and financial conglomerates, this has to be considered from the supervisory perspective, where having the general scope of the tasks defined under Option 2 has to be more effective and efficient. Undertakings however would consider that Option 1 is probably more efficient and effective from their perspective as it would allow the actuarial function (which may be shared across a group) to be focussed in the most important areas.
- 4.33. From a sustainability perspective, Option 2 is considered to better meet that; it is likely that there would be pressure to move away from Option 1 if experience showed that the standards to which the mandatory tasks were being performed were inconsistent. Option 2 would also deliver far greater consistency than Option 1.
- 4.34. CEIOPS' view is that, overall, Option 2 better meets the operational objectives set by the Commission.

Issue C. The reporting of the actuarial function

- Option 1. Require annual reporting with definition on Level 2 of its structure and content.

- Option 2. Require annual reporting but leave the decision on the details up to the undertakings.

Cost and benefits

- Policyholders and Beneficiaries

- 4.35. Both the options considered will only have an indirect impact on policyholders, depending on the quality of the advice given to the administrative and management body. The better the quality of advice, the more likely it is that the interests of policyholders will be protected and benefits and premiums will reflect the underlying risks. Option 1 would aim to define the structure and content, and is likely to deliver more consistent reporting. Option 2 on the other hand may result in management not being as well informed as otherwise would be the case.

- Industry/(re)insurance undertakings

- 4.36. Option 1 is clearly more prescriptive, but this is likely to result in the indirect impact of management being able to make better informed decisions than might otherwise be the case. The standardisation of the structure and content might also make it more apparent to management where there may be issues but, as the report is only annual, that degree of standardisation may be of limited benefit.
- 4.37. While Option 2 gives greater flexibility in the annual reporting, it is less likely to lead to management being as clearly informed of the issues arising as under Option 1, and management may be more likely to act in way that is not in the best interests of the undertaking.

- Supervisory authorities

- 4.38. With Option 1, supervisors' resources spent looking at the results of the actuarial function should be lower than under Option 2 as the structure and content of all the reports will be similar, and issues are more likely to be easier to identify.
- 4.39. Option 2 on the other hand means that each report will be unique and it will be less easy for supervisors to compare undertakings or necessarily identify the salient issues. Thus Option 2 is likely to require more supervisory resources to monitor. However, as the mandatory tasks will have been carried out, the lack of consistency may not be important from a supervisory perspective.

Comparison and ranking of the policy options based on the efficiency and effectiveness of each option in reaching the relevant operational objectives

- 4.40. In terms of delivering proportionate requirements for small firms, Option 2 is

expected to be more effective and efficient as it can reflect the individual nature of each undertaking. Option 1 is likely to deliver a degree of standardisation in internal reporting which has little impact on the operation of the actuarial function.

- 4.41. When it comes to harmonising supervisory powers, methods and tools, regard has to be made of the primary purpose of the report, which is to inform management and not the supervisory authorities (although they make use of the report). As such, it seeks to improve the quality of actuarial function by bringing to management's attention issues that have been identified during the year. Thus, although the report is not a supervisory power, method or tool, it might assist supervisors to understand any issues that have arisen in regard to the actuarial function. Then, it is considered that Option 2 is a more effective way of ensuring management are advised, in a format that can be specific to the undertaking, than Option 1.
- 4.42. As these reports are for internal purposes primarily at each undertaking, neither option promotes compatibility of the prudential regime of EU insurers with the work of the IAIS and IAA (where there are no equivalent standards), or specifically ensures efficient supervision of insurance groups and financial conglomerates.
- 4.43. Turning to sustainability, Option 2 is more likely to achieve that than Option 1, where the definitions of the structure and content may be too prescriptive, especially as the primary purpose of the report is for undertakings. In the case of the consistency objective, Option 1 certainly achieves greater consistency in the reports between undertakings, but that is not the objective of the report.
- 4.44. Thus overall, CEIOPS considers that Option 2 best meets the objectives set by the Commission, as the purpose of the report is for each undertaking's management and any use for supervisory purposes is only ancillary, where the proportionality objective is considered to carry the most weight.