



A COMMON SUPERVISORY CULTURE

Key characteristics of high-quality and effective supervision



eiopa
EUROPEAN INSURANCE
AND OCCUPATIONAL PENSIONS AUTHORITY

FOREWORD



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Building a common supervisory culture is a strategic goal of the European Insurance and Occupational Pensions Authority and a fundamental step to ensure the development of high-quality, effective and consistent supervision across the European Union and safeguard a similar level of protection to all European policyholders.

This booklet is the result of a joint and common effort and I would like to thank everyone who has contributed to its development. It outlines the most important elements of high-quality and effective supervision, ranging from the principles that underpin a common European supervisory culture to the basic conditions and tools needed. It is one of a number of tools that EIOPA has developed to both support supervisors at a national level and promote supervisory convergence at European level.

A common supervisory culture is not something that can be built overnight. But, working together, step by step, we can build a strong and fair supervisory culture that promotes consumer protection and enhances the stability of the financial system for the benefit of Europe's business, economy and citizens.

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I. BACKGROUND

The purpose of the paper is to establish a European approach ⁽¹⁾ towards risk-based supervision by defining a common supervisory culture. A key part of this definition is to identify and describe the key characteristics of high-quality and effective supervision.

The approach described in this paper should be read considering the broader framework of the supervisory review process, including all relevant provisions of Directive 2009/138/EC of 25 November 2009 of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance (the solvency II directive) and the different tools developed by EIOPA.

Tools developed by EIOPA for the different areas of the supervisory review process complement this paper. They include *EIOPA's Guidelines on supervisory review process*, published in 2015 ⁽²⁾, and *EIOPA's strategy towards a comprehensive risk-based and preventive framework for conduct of business supervision* ⁽³⁾.

A common supervisory culture will underpin convergence of supervisory practices, including a common interpretation of the laws and regulations, without prejudice to the application of the proportionality principle.

The solvency II framework has embedded principles that should be considered at each step of the supervisory review process and in the implementation of each of the key characteristics identified in this paper. In this context EIOPA underlines the importance of considering the European Union dimension of the insurance sector and of insurance sector supervision. Given the globalisation of financial services and the increased importance of international standards, dialogue and cooperation with supervisors inside and outside the EU should be fostered.

⁽¹⁾ This approach covers European Union Member States and includes, where appropriate, the European Economic Area (EEA) subject to the conditions of the EEA Agreement.

⁽²⁾ <https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-supervisory-review-process>

⁽³⁾ https://eiopa.europa.eu/publications/reports/eiopa-16-015_eiopa_strategy_on_conduct_supervision_framework.pdf

II. SUPERVISORY CULTURE

EIOPA and national competent authorities (NCAs) have been working together over a number of years towards enhanced cooperation and open dialogue to promote this common culture. This ongoing dialogue and exchange of experiences between NCAs has been crucial, and EIOPA plays an important role in facilitating this dialogue. Step by step, EIOPA and NCAs work together as a team with a common duty to European policyholders. This dialogue is essential to extract the utmost added value from each key characteristic identified in this paper.

The European supervisory culture can be defined as a common understanding of the way supervisors think, behave and work within their community. This culture manifests itself in processes and procedures, but also in behaviour. In arriving at a common culture, processes and procedures are easier to align than behaviour. The objective is to align at different paces.

One of the issues that is key to establishing a common culture is having a common understanding of supervisory objectives and a common view on the key characteristics of high-quality and effective supervision.

III. OBJECTIVES

The main objective of supervision is the protection of policyholders and beneficiaries. A similar level of protection should be provided to policyholders and beneficiaries across jurisdictions regardless of the location of the insurance or reinsurance undertakings' (hereinafter: insurance undertakings) head office. NCAs should promote the safety and soundness of insurance undertakings, focusing on the risks that they face or could face in the future.

It is also an objective of NCAs to duly consider the potential impact of their decisions on the stability of the broader financial system, especially in times of exceptional movements in the financial markets.

These objectives should be reached in an efficient and effective manner.

The protection of policyholders and beneficiaries needs to be seen from a broad perspective, as there is a close interrelationship between market conduct and prudential issues. The role of supervisors is to ensure that insurance undertakings are soundly managed and have an effective system of governance and a robust solvency position (current and prospective) in order to make sure that they can fulfil all their commitments while ensuring that they act honestly, fairly and professionally in accordance with the best interests of policyholders and beneficiaries.

To do so NCAs should be provided with the necessary means and powers, such as the relevant expertise, tools, capacity and mandate to achieve the main objective of supervision.

IV. PRINCIPLES AND KEY CHARACTERISTICS OF HIGH-QUALITY AND EFFECTIVE SUPERVISION



RISK-BASED AND PROPORTIONATE



The insurance business model is based on the pooling or transfer of risks. As a result of their business models insurance undertakings are exposed not only to insurance-specific risks but also to the risk of financial market losses and operational risks, similar to other financial businesses. Risk exposures are influenced by the nature and complexity of the business, by how the risk management system of the undertaking is aligned to the risks it engages or simply by their size and interconnectedness with the rest of the financial system. This requires NCAs to recognise relevant risks and intervene at an early stage. Under a risk-based supervisory regime, supervisory efforts should focus on the market

participants that pose the highest risks to the objectives of supervision. For conduct of business there should also be consideration of situations of possible specific detriment for policyholders and beneficiaries that might not be directly linked to a 'financial failure'.

This allows for a risk-based approach to supervision in which the frequency and intensity of supervision depends on the potential impact and probability of an insurance undertaking's failure. In the assessment of the impact and probability of an insurance undertaking's failure both the potential financial impact of any failure and the probability of the failure need to be considered. The potential impact depends inter alia on the size, type of business, risk appetite and risk tolerance of insurance undertakings and on the complexity and interconnectedness of the business, while the potential probability should also consider qualitative criteria especially linked with the undertaking's specificities, such as the business model, including strategic planning, management and conduct of business. Regarding conduct of business supervision, a risk-based approach also implies identifying the depth and scale of issues relating to products or services and focusing priorities and resources where they matter most.

A risk-based system allows NCAs to prioritise and use their own resources efficiently and effectively. It is important that relevant risks be kept on the radar even when identification or measurement is more complex. Risk-based prioritisation should be complemented by an assessment of the potential reputational risk to the market or risk of market disruption that the failure of an undertaking (even if low impact) could have on the market as a whole.

To achieve the objectives of supervision all insurance undertakings should be subject to a minimum level of supervision supported by a proper risk assessment and taking into account policyholder protection and any cross-border business. A purely reactive approach from NCAs to these smaller insurance undertakings may not accurately reflect the actual risk to their policyholders and the market. A build-up of risks across a number of smaller insurance undertakings in aggregate can create vulnerabilities in the financial system and jeopardise the objective of

policyholder protection. Therefore, a proactive approach to supervision, tailored to the relevant risks of smaller insurance undertakings, should also be undertaken.

The proactive approach towards smaller insurance undertakings should be defined based on the NCAs' assessment of the risks that insurance undertakings face or may face and their ability to properly manage those risks. The assessment at least every 3 years ⁽⁴⁾ of the supervisory information reported regularly could be used as a checkpoint to reassess whether the defined scope and frequency of the comprehensive review of such undertakings is adequate.

A risk-based regime should be able to see the market as a whole and incorporate its developments, including distribution channels and products. On the one hand, product oversight and governance arrangements play an important role in the protection of policyholders and beneficiaries by ensuring that insurance products meet the needs of the target market and thereby mitigate mis-selling. On the other hand, having an understanding of the products sold by the different insurance undertakings enables the supervisor to have a proper discussion on the appropriateness of assumptions and methods used by undertakings (e.g. loss reserve for long-tail product lines).

NCAs must also acknowledge the abovementioned interlinkages between prudential supervision and conduct of business supervision. Conduct issues not only harm individual policyholders and beneficiaries but can also have a wider financial impact on the insurance market. For instance, poor conduct of business, such as mass mis-selling, can have a detrimental impact on the market. Recognising this issue as a major supervisory priority leads to high-quality and effective supervision for all Member States, whether these competencies are within the remit of the same national supervisor or are distributed to several competent authorities.

⁽⁴⁾ Connected to the receipt of the full regular supervisory report every 3 years.

FORWARD-LOOKING, PREVENTIVE AND PROACTIVE



Supervisors need to understand the insurance market to be able to consider the evolution of the market and allow for a forward-looking view of the risks. Supervision assesses not only the current risks but also those that could potentially arise in the future, including emerging risks. While an understanding of the past helps in some cases, the understanding of the current and future market is more important. It is essential that supervisors focus on 'what can go wrong?' rather than only on 'what went wrong?'

To enable this forward-looking perspective it is also necessary to understand an undertaking's attitude to risk management. There is a direct link between the risk culture of an undertaking and the quality of its actual risk management framework and practices.

A forward-looking perspective covers all types of future changes that might impact on insurance markets, insurance undertakings or products. The supervisory review process should take account of changes not only in the economic and legal environment but also in the social, behavioural and cultural environment. In this context the supervisory review process should be able to adapt to new emerging risks, such as new technologies (digitalisation) and their impact on business, and risk management and internal controls.

Supervisors should generally intervene at an early stage in order to minimise disruption or loss on the part of policyholders and beneficiaries. This includes situations in which vulnerabilities are detected as regards the sustainability of the business model, the system of governance or capital adequacy. Also, in conduct of business supervision policyholders' and beneficiaries' detriment should be anticipated by supervisors rather than just reacting following the emergence of problems. That is, supervisors should anticipate the problems of the future, rather than focusing on those of the past. This can only be done through a forward-looking approach that concentrates on how to best

identify and tackle, in a timely and effective manner, emerging risks for policyholders and beneficiaries. Market monitoring, data gathering and the ability to apply business intelligence to the data are crucial to this approach, as is the use of professional judgement.

This approach should enable supervisors to be forward looking, plan ahead for their supervisory review process and execute supervisory actions and timely measures, i.e. to be proactive.

NCA's should take into account the procyclical behaviour of insurance undertakings and the potential procyclical effects of their actions. Actions aimed at protecting policyholders and beneficiaries from losses may also inadvertently encourage behaviour that worsens movements in financial markets. NCA's should promote suitable behaviour in good times, leading to insurance undertakings being able to live through the economic cycle without jeopardising their future financial condition. Strategies regarding, for example, the business model, investment portfolio or capital planning that only consider the positive part of the economic cycle are not adequate.

NCA's shall be able to require an insurer to take both preventive and corrective measures in a timely manner if the insurer fails or is expected to fail to operate in a manner that is consistent with regulatory requirements and relevant sound business practices in this context. Taking preventive measures implies acting before any non-compliance with certain rules or regulations and even before financial deterioration.

The development of a clear communication strategy and proactive use of communication tools by NCA's influence the behaviour of different stakeholders and foster market discipline. They may also clarify NCA expectations concerning specific topics.

CHALLENGING, SCEPTICAL AND ENGAGED



Insurance undertakings are free to define their business strategy in order to create value in the long term and in line with their risk appetite. Without interfering with entrepreneurial freedom, supervision needs to question undertakings' assessments and challenge their conclusions and decision-making processes. Challenges should cover all relevant and material areas that may have an impact on an undertaking's viability, from the details on the assumptions used in the calculation of technical provisions to the business model and strategy adopted.

Such a challenge is only possible with a comprehensive and intimate knowledge of the supervised entity by supervisors ('close to the bone'). Supervisors should make use of all information available to form their own opinion on the way insurance undertakings conduct their business and manage their risks, including the sustainability of the business.

The initial off-site analysis of information available from supervisory reporting, regular or ad hoc, and other sources of information, needs to be complemented by an appropriate combination of a detailed review and on-site activities, if relevant.

This challenge and scepticism is often called intrusive supervision. In fact, insurance undertakings and NCAs pursue objectives that may be seen as contradictory at first glance. Both parties need to be aware of this fact and ensure that it does not prevent them from engaging in an open and fair dialogue, without constraints, where both sides are able to apply the same approach regarding openness, business knowledge, experience and transparency. It is not possible to fully understand an undertaking and its business without ongoing dialogue. The intensity and frequency of this dialogue may differ depending on the undertaking's risk profile and the attitude of the undertaking to supervision.

Challenging insurance undertakings in an intrusive but justified manner, while applying professional scepticism together with integrity and fairness, contributes to open discussions between NCAs and undertakings.

COMPREHENSIVE



Without a comprehensive view of the relevant markets, entities and products, supervisors run the risk of missing the identification of important risks. Supervisors must be constantly vigilant in identifying emerging risks that may have important consequences for the insurance undertakings they supervise. This is only possible if supervisors are up to date with economic markets, other sectors' developments, social phenomena, accounting and relevant regulatory developments or any other events that may impact risks. This also includes systemic risks and those arising from interconnectedness within the insurance sector and across sectors.

Ongoing dialogue and exchanges of experience between NCAs are crucial, and EIOPA plays an important role in facilitating this dialogue. The splitting of tasks and responsibilities when it comes to supervision of the cross-border activities of EU insurance undertakings has led NCAs, step by step, to work together and with EIOPA in a team environment, having in mind a common duty.

When an undertaking directs a significant part of its business towards Member States that are not the Member State of authorisation, the relevant NCAs should ensure a similar level of protection for policyholders across the Member States regardless of the location of the insurance undertaking's head office.

In this regard it is important for NCAs to comply with the decision on the collaboration of insurance supervisory authorities ^[5], which provides for specific information flows between supervisory authorities on the authorisation, notification and ongoing stages of supervision. Exchanges of information can take place on a bilateral basis or through broader forums such as the colleges of supervisors or other specific cooperation platforms.

It is also important to maintain an appropriate level of cooperation with other competent authorities connected

^[5] EIOPA-BoS-17/014.

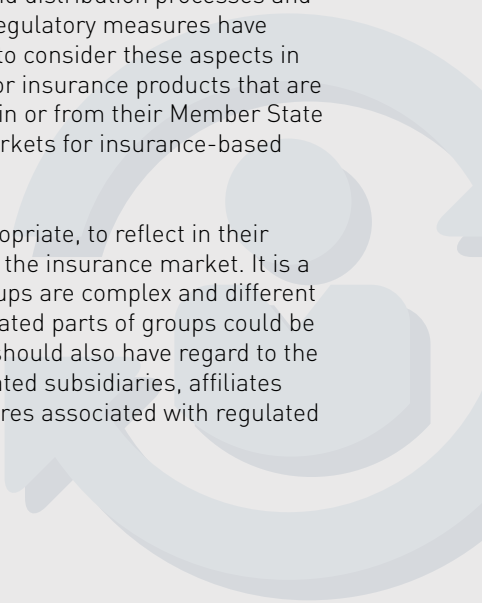
with the insurance market, if they are separate authorities, such as authorities responsible for the supervision of credit institutions or financial markets, central banks, bodies involved in the liquidation and bankruptcy of insurance undertakings and other relevant bodies.

An open and constructive dialogue between NCAs and the statutory auditor(s) and the audit firm(s) carrying out the statutory audit strengthens the supervision of insurance undertakings. This dialogue may take several forms. NCAs should consider setting up a suitable form of regular dialogue with statutory auditors to allow an exchange of views on current and emerging developments.

Supervision should also consider business models and strategy, corporate culture, integrity and decision-making processes.

In the area of conduct of business additional areas of supervision should be considered, including product oversight/monitoring, sales and distribution processes and post-sales handling. Recent regulatory measures have reinforced the need for NCAs to consider these aspects in supervisory processes, monitor insurance products that are marketed, distributed or sold in or from their Member State and monitor their national markets for insurance-based investment products.

Supervisors need, where appropriate, to reflect in their processes the globalisation of the insurance market. It is a fact that the structures of groups are complex and different regulations or even non-regulated parts of groups could be a source of risk. Supervisors should also have regard to the role and relevance of unregulated subsidiaries, affiliates and off-balance-sheet structures associated with regulated institutions.



CONCLUSIVE

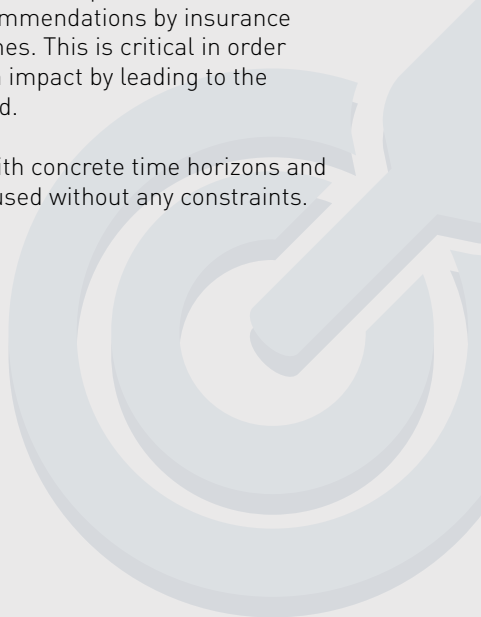


Supervisors must draw conclusions and follow up on matters as soon as possible and in an appropriately timely manner, following a due process through the supervisory review process. Identified issues cannot be left without a proper conclusion and action plan.

Once supervisors have drawn their conclusions these should be appropriately communicated to the insurance undertaking. This communication can take several forms and its level of formality can vary depending on the severity of the situation and on existing supervisory powers. When being conclusive, supervisors will often have to balance the need for comprehensive information with the need to act proactively, without being fully informed, before a risk materialises.

After a detailed review performed off-site or an on-site inspection, supervisors should follow up on the final resolution of findings and recommendations by insurance undertakings within set timelines. This is critical in order to lead to changes and have an impact by leading to the mitigation of the risks identified.

Clear supervisory measures with concrete time horizons and follow-up activities should be used without any constraints.



V. GOVERNANCE OF THE SUPERVISORY REVIEW PROCESS

The implementation by NCAs of appropriate decision-making processes and procedures, including documentation, supported by a clear rationale, should lead to a predictive and forward-looking judgment.

The use of supervisory judgement is key to supervision. Analysing insurance undertakings is a complex task. Different perspectives, dependencies and diversification effects, along with qualitative aspects, need to be considered in any analysis. It is therefore not prudent to base conclusions solely on automated processes without the proper consideration of expert judgement. This should be accompanied by flexibility in the supervisory review process to reflect the fact that the environment is constantly evolving.

One challenge — but one that is also a goal — is to ensure the treatment of all insurance undertakings is consistent. NCAs should be able to assess the consistency of supervisory outcomes over time and between undertakings.

The regular review of the implemented supervisory review process, including an assessment of the efficiency of the methodologies and tools used to identify risks, is of the utmost importance. The sharing of experiences and lessons learned from this regular review with other NCAs and with EIOPA is of key importance.

NCAs are required to disclose, among other information, the objectives of the supervision and its main functions and activities, along with the general criteria and methods, including the tools used in the supervisory review process. This publication should be kept up to date and should reflect the review of the supervisory review process and any discussions at European level.

VI. THE TOOLS NEEDED

A common supervisory culture requires basic tools to be available in any NCA.



LEGAL STANDING: the competent authority for the supervision of the insurance and reinsurance market should have the authority and appropriate powers to fulfil its tasks. The definition of clear objectives, usually but not necessarily in the law, is very important.



PROPER GOVERNANCE STRUCTURE: NCAs need to set themselves high governance standards. NCAs need to have in place adequate processes and procedures for supervision that are regularly assessed and reviewed. It is also critical that the decision-making process be challenged within the authority, in particular with regard to decisions on supervisory measures. Principles such as independency, transparency and accountability should be applied by all supervisors in their daily tasks.



CLEAR DEFINED STRATEGY: financial markets are constantly evolving, and supervision needs to be flexible and proactive to be able to focus on the relevant areas at any time. To take the above into account, a clear definition of the NCA's strategy and work plan, at least annually, allows proper planning and setting of priorities and timelines. In particular, such planning might essentially be 'operational' planning, taking into account impact/probability of risks stemming from supervised entities (following a bottom-up approach), but could also be complemented by 'strategic' planning that defines the strategic priorities set considering the specificities of local markets, the risk and vulnerabilities at the macro level or the positions of other competent authorities.



PROPER PROCESSES FOR COOPERATION WITH OTHER COMPETENT SUPERVISORS AND EIOPA:

NCA's should have in place processes that ensure proper dialogue with other supervisory authorities (e.g. of the financial market), at both the national and the international level, and ensure that common European practices are duly considered/taken into consideration/ followed when making interpretations and decisions and exercising supervisory powers. A continuous exchange of information is needed to ensure that NCAs at all times have a detailed view of the products that are being sold and the institutions that are active on the market.



ADEQUATE RESOURCES: from both a human and a financial perspective. NCAs need to have sufficient supervisory skills and competences to guarantee that, as a whole, they maintain the proper legal and technical knowledge and behavioural skills. It is important that this expertise be recognised by market participants. Supervisors need to be aware of national and international developments and follow any developments that are relevant for the market. Material resources such as IT (hardware and software), security standards, access to relevant information sources, etc. should be guaranteed. The supervisory review process cannot be implemented without proper IT systems and business intelligence tools in place.

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