Financial Services Commission

Feedback Paper

Self-Assessment templates on Systems of Governance and Forward Looking Assessment of Own Risks

Date of Paper : 1 Oct 2014

Version Number : V1.00

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Published by:

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1. Introduction

In the FSC "Update on Solvency 2" published on 17 September 2014, our expectations in respect of Pillar 2 were set out as follows.

"Firms should be undertaking the following:

a) Actively progressing their plans to meet the required governance requirements (including meeting the existing regulatory requirements set out in Guidance Note 14 in December 2013);
b) Finalising their FLAOR report for submission to FSC in the near future, and no later than 31 December 2014;
c) Considering how to embed the governance requirements in their firm, and how they will demonstrate this to the FSC, ie. this is not just a paper production exercise."

Throughout 2014, the FSC has been interacting with licensees to ascertain the overall state of Solvency II preparedness of the Gibraltar market. As part of this process, firms were asked in March 2014 to submit a self-assessment template covering the governance guidelines as outlined in the Insurance Guidance Note No 14 ("GN14") as well as the Guidelines on Forward Looking Assessment of Own Risks guidelines as set out in our Dear CEO letter of 15 November 2013.

As a reminder, the firms were asked to assess one of the following scores to each guideline

1. Not in place and work not yet commenced
2. Started and substantial work remains
3. Close to finished
4. Fully compliant

These templates were reviewed by the FSC and a request for supporting documentation in specific areas, where companies had assessed their state of readiness as 4, was sent out at the end of July 2014. The information supplied in both the original templates and the supplementary documentation form the basis of this feedback paper.

2. Guidance Note 14 feedback

2.1. General Observations

In general, there was considerable variation in the detail provided in the accompanying text which made it difficult to fully evaluate the submissions in a number of cases. Some companies provided the same response for several areas, despite the guidelines covering different aspects of governance. A few companies supplied no text at all.

Where the "current" guidelines were not in place at a firm, the FSC expected to see evidence of a gap analysis, an action plan with deadlines and a high priority to ensure full compliance within a short timeframe, but this was rarely reflected in the text. It may well be that such actions are either planned or are taking place but this will not be clear until the next self-assessment exercise has been completed.

Examples of unrealistic timetables were also seen with companies anticipating moving from a score of 1 or 2 to full compliance, within 3 months. This might be achievable if the company has recently put a plan in place and resourced the project appropriately, but the supporting text provided did not support this. Therefore these deadlines appear to be overly optimistic.

There was evidence that insufficient thought had been given to a logical sequence of development to the completion of outstanding guidelines. An example of this was where companies were anticipating being close to, or had reported, full compliance against the Fit or Proper requirements guidelines, even though they claimed to be some way off finalising a Fit and Proper Policy. Over half of the respondents indicated that substantial work remained in the formulation of their Fit and Proper policy.

Only in a few submissions, was reference made to an overall SII plan or programme, which was surprising. The more complete responses all had this as a common thread and demonstrated that there was both a plan and clear ownership and responsibilities in place. In these responses, the Board's role in the Solvency II exercise was pivotal.

Where companies had reported themselves as being a 3 against a guideline, this appears to be due to the documentation being in draft form, or awaiting formal testing, or that it was to be reviewed at the next Board meeting. We would expect to see these areas as being complete, at least for the "current" guidelines, and reported as such by the time of the next assessment.

In the responses on internal controls, it was not clear from the text whether staff were fully aware of their role in internal controls as the emphasis appeared to be on a "top-down" approach with very little commentary on how policy is implemented in practice. Also, the role of Internal Audit seems to be over-emphasised with several examples of companies appearing to use this function as the only internal control, rather than as a key component of the controls. Further clarification on these points will be sought during the next exercise.

Similarly, in the area of monitoring and reporting, the feedback concentrated on reporting but little commentary was provided on monitoring. This may well be taking place but there was little evidence provided during this exercise. This is another area where the FSC will expect clarification during the next self-assessment exercise.

Given the majority of firms operate a primarily outsourced business model, and that guidelines 2.42 to 2.45 covering outsourcing are all "current" guidelines, the FSC had anticipated that firms would already have been at the very least close to compliant. The FSC Guidance Note 2 on Outsourcing provides further assistance in this area. The FSC will be carefully reviewing firms' progress in this area.

With respect to the responses to the self-assessment questions on groups, some firms completed these even though our preliminary view is that we do not believe the firm will form part of a group under Solvency II, and conversely firms which we initially view as likely to form part of Groups did not complete these questions. We will shortly be finalising our view on which firms will fall within the scope of group supervision and will be in touch with relevant firms in due course to clarify their status.

2.2. Review of Supplementary Documentation

In July 2014 firms were asked to supply specimen policies and procedures across a selection of the guidelines where they had assessed themselves as a 4. This was to assist the FSC validate the responses provided and better understand the methodology used by firms to meet the guidelines. A small number of companies were also asked to supply their Solvency II project plans for review.

Overall, the quality of the documentation was of a consistently high standard and was fit for purpose, suggesting that these companies had fully understood the guidelines and appreciated the business imperative of achieving compliance.

Board and Sub-Committee Terms of reference followed a broadly-similar format, although not all of the documents were signed and several lacked copies of the authorities referred to in the documents. Where structure charts were supplied, it was easier to understand the interdependencies between the different groups. The membership of the various committees appeared to be appropriate with clear independence established where appropriate eg Audit.

Good examples were seen of comprehensive, over-arching control frameworks such as a "Corporate Governance Policy" or an "Internal Control Policy". These were usually controlled by the Audit or Risk functions and were modelled on the GN14 guidelines. A number of separate sections such as Outsourcing or Training all reported upwards to the Board via this conduit. This allowed the Board to receive a high-level report which covered all aspects of governance. The size of the firm would not be a factor in developing this kind of approach as it would be proportionate to the scale and nature of the business.

Further work is needed on documents which have been supplied by either the parent company, or an outside consultancy, without adequate tailoring to the needs of the local operation. The FSC will be following up on these with the companies concerned to ensure that only policies and procedures that are fit for local purpose are adopted.

Reviewing the plans showed that the majority of actions planned would take place during Q3/Q4 of 2014, with the final work being completed before 30 June 2015. Only in a few cases did the plan show deadlines later than this. Whilst the level of detail provided varied, common elements in the plans were as follows.

1. Board ownership with regular reporting mechanisms and a standing item at Board meetings.
2. Delegated, dedicated resource, working across a number of different business streams according to skill sets.
3. Gap analysis used as the basis to formulate action plans.
4. Separate budget with appropriate authorities within Project team.
5. Deadlines with priorities, milestones and review dates. A simple "RAG" (Red/Amber/Green) monitor was often used.
6. Communication programme, addressing all stakeholders.

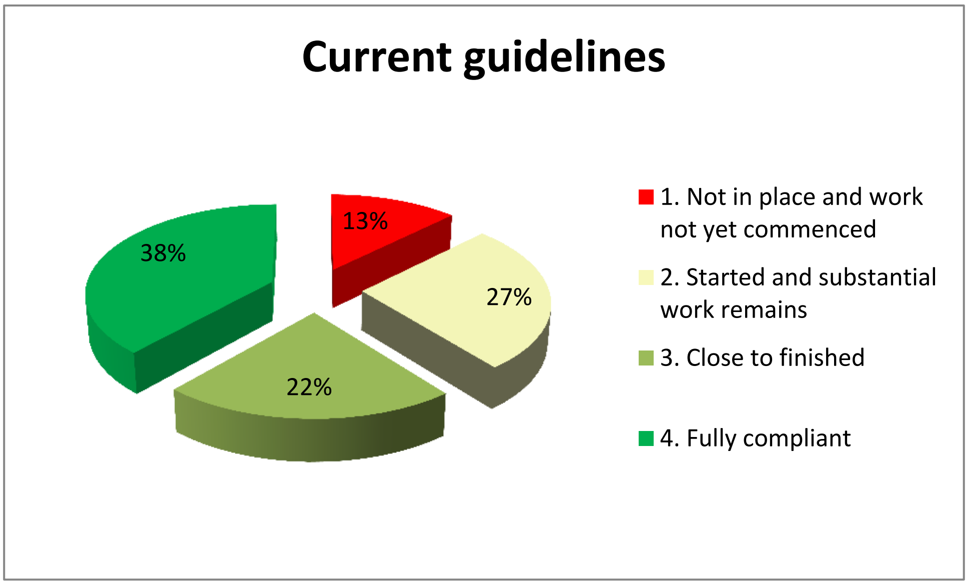
A small number of the plans supplied appear to be at the draft stage and lack sufficient detail to be credible. In these circumstances, a lack of resource and a clear link to the Board appear to be absent. These will be discussed individually with the companies over the next few weeks to ensure that a full understanding of their plans is obtained.

In sections 2.3 and 2.4 we will further analyse the two subsets of the GN14 guidelines.

2.3. "Current" (Guidelines which should already be met)

The initial focus of the review was to assess how firms were compliant with the "current" guidelines as outlined in GN14 i.e. those that were not listed in Appendix 1 of GN14. As the note had been issued in December 2013 and adherence to these guidelines was seen as evidence that the firm was meeting the criteria of sound and prudent management, it was anticipated that the majority of respondents would be indicating full or substantial compliance against these.

Analysis of the responses indicates that this is far from the case and that the market has not understood, or has not paid sufficient attention to GN14. Using full compliance with the "current" guidelines as the starting line for a Solvency II plan, many firms still have considerable work to do.



The 5 areas where firms have assessed themselves as being the least prepared to meet the "current" guidelines, indicated by a score of either 1 or 2 in their templates, are as follows, using the numbering from GN14:

- 2.20: Asset-liability management policy.
- 2.11: Fit and proper policies and procedures.
- 2.42: Outsourcing, critical or important operational functions and activities.
- 2.16: Underwriting and reserving risk management policy.
- 2.22: Liquidity risk management.

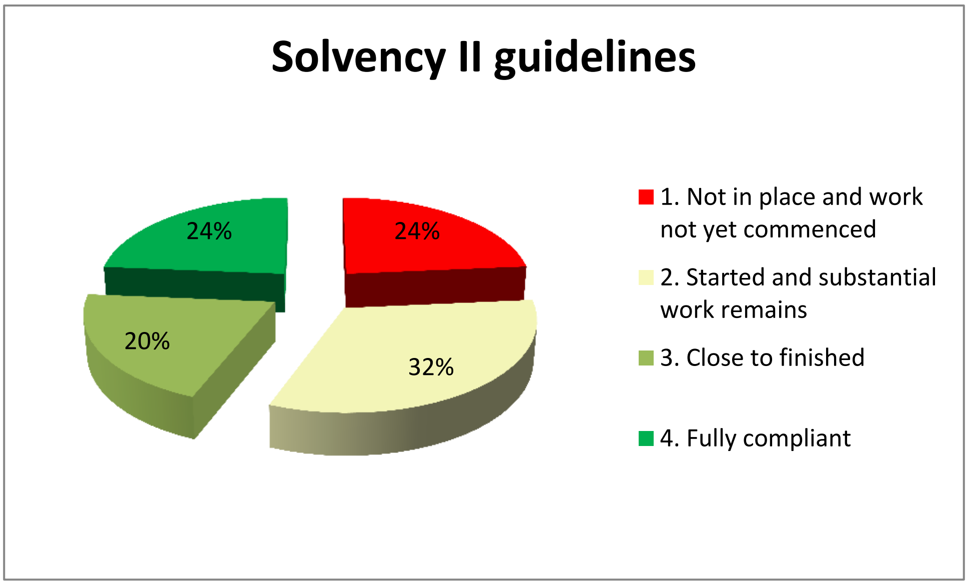
The 5 areas where firms have assessed themselves as closest to compliance with the guidelines, indicated as a score of 4, are as follows;

- 2.1: The Board.
- 2.2: Organisational and operational structure.
- 2.4: Decision-making.
- 2.9: Fit requirements.
- 2.10: Proper requirements.

2.4. Solvency II requirement Guidelines

The focus of this aspect of the review was to establish a first "snap-shot" of how advanced the Gibraltar market was against the Solvency II requirement guidelines, in respect of which firms are expected to demonstrate that they are taking the necessary steps to ensure compliance with the corporate governance requirements established under the Solvency II Directive when that Directive takes effect, but are not currently expected to be meeting the guidelines. Analysis of the responses indicated that the majority of firms had at least started to prepare for Solvency II with relatively few scores of 1 reported.

In several cases, firms had already completed the necessary work to ensure compliance, or were close to finalising their approach and documentation. It was clear that few firms had focussed purely on the "current" guidelines but were instead taking a more holistic approach and developing a full governance programme, covering both "current" and "Solvency II" requirements. This is to be welcomed.



The 5 areas where firms had reported the least progress against the "Solvency II" guidelines, indicated by a score of 1 or 2 in their template, were as follows:

2.30. Medium Term Capital Management Plan

2.29. Capital Management Policy

2.34. Internal Audit Policy

2.38. Data Quality

2.14 Risk management Policy

The 5 guidelines where firms had expressed the highest degree of preparedness, indicated by a score of 4, were as follows;

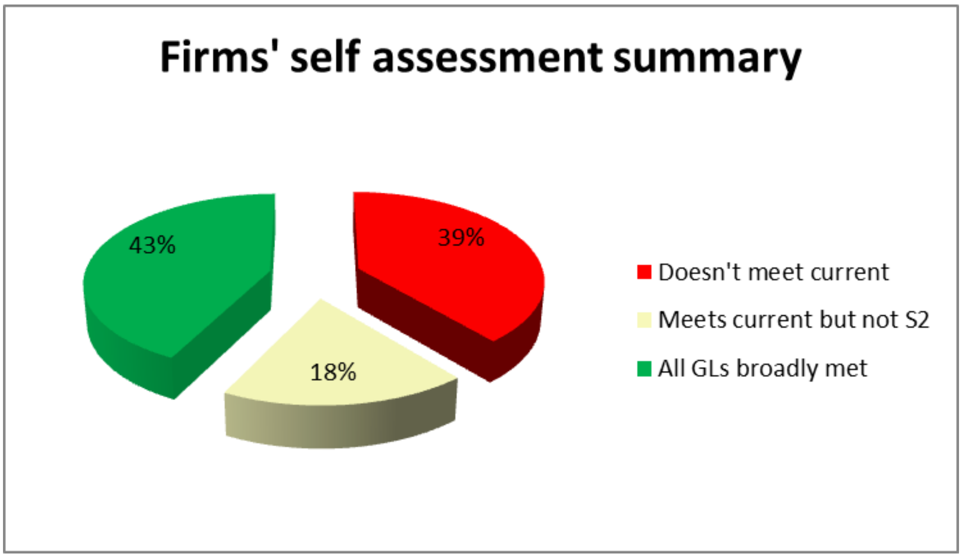
2.15. Risk management Function General Tasks

2.23 Investment Risk Management

2.41 Actuarial Reporting to the Board

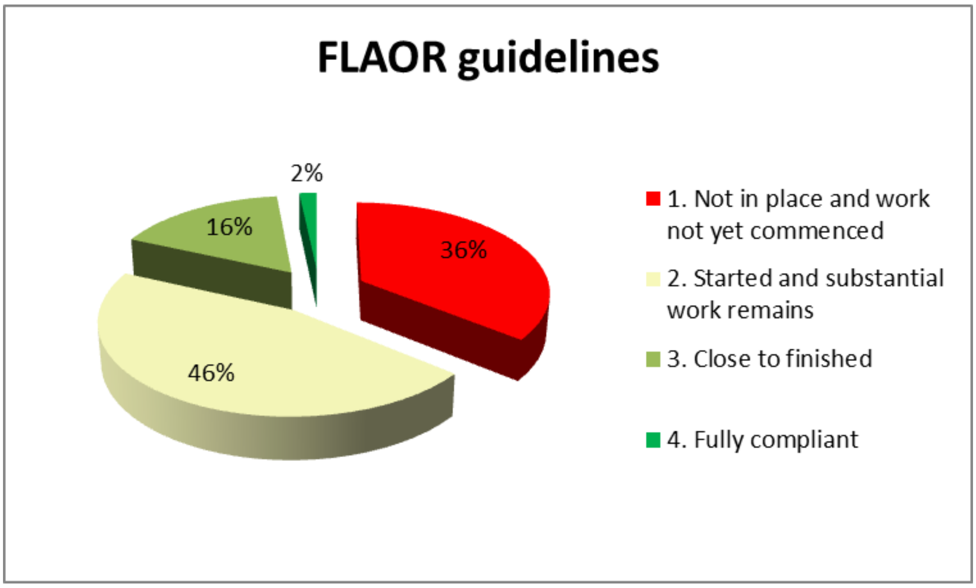
2.13. Role of the Board in the Risk Management System

2.33 Independence (Audit Function)



The above chart shows that 39% of firms fell into the "Red" band where they scored the majority of the "current" guidelines as a 1 or 2 i.e. typically not meeting "current" guidelines. Conversely, 43% of firms fell into the "Green" band when they scored the majority of the "Solvency II" guidelines as a 3 or 4. The other 18% fell somewhere in-between.

3. FLAOR commentary



Overall, the responses to the questions revealed a disappointing picture as can be seen above, especially as firms' initial FLAOR reports are due shortly, and not later than year end.

Particular areas that need addressed by firms without undue delay therefore are:

- Documentation related to FLAOR
- Demonstration of how a firm's solvency needs – both now and projected – relate to the risks a firm faces
- Demonstration of how a firm's FLAOR influences key aspects of a firm's business such as capital management and business planning

These may well now be in hand given the approaching deadline for submitting FLAOR reports to the FSC.

4. Next Steps

Firms will be requested to submit a second self-assessment to be submitted by 28 November 2014. This will be for the systems of governance guidelines only. For FLAOR, we expect that the submission of firms' FLAOR reports will allow us to judge progress on this front.

To simplify this process, the original templates should be re-submitted, highlighting the changes in the "scores". Where the score has changed, an explanation should be provided in the text column of the actions taken. Even if the score has not changed, firms should record what actions they have taken. An update should also be provided if on further reflection the firm feels it should be amended to give a truer and fuller picture of the firm's progress.

Where the company has not already submitted its Solvency II plan, this should be submitted with the template. An updated plan should be submitted by those companies who have already supplied their plans as part of the previous exercise. In respect of the guidelines that firms need to meet in time for Solvency 2, we would expect to see solid progress towards meeting these.

Finally, as set out in the introduction to GN14, where firms are not following the "current" guidelines, they will be expected to explain what other approaches are being adopted to ensure that the firm conducts or will conduct its business in a sound and prudent manner. This explanation should be provided with the template for the "current" guidelines only.

Given the content of this feedback paper, and the importance that the FSC attaches to this, the FSC would be grateful if a copy was brought to the attention of the Board of Directors.