Financial Services Commission

Response to Consultation Paper

System of Governance - Insurance

Transition to Governance Requirements established under the Solvency II Directive

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Table of Contents

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Summary

The European Insurance and Occupational Pensions Authority ("EIOPA") published final "System of Governance" Guidelines on 31 October 2013. These Guidelines apply to National Competent Authorities ("NCAs"), such as the Financial Services Commission ("FSC"), and provide guidance as to how NCAs should proceed in the preparatory phase leading up to the application of the Solvency II Directive.

These Guidelines are seen as essential for fostering preparation with respect to key areas of Solvency II in order to ensure proper management of undertakings and to ensure that supervisors have sufficient information at hand. The EIOPA Guideline sets out 52 Guidelines relating to corporate governance arrangements that should be in place for individual insurance and reinsurance undertakings ("insurance undertakings / insurers") and at the level of the group. Current Gibraltar legislation sets out requirements for an insurance undertaking to manage its business in a sound and prudent manner. The FSC has issued two Guidance Notes on "Systems of control over investments (and counterparty exposure) including the use of derivatives" and "Systems of control over general business claims provisions". However, it has not previously provided guidance on matters directly relating to Corporate Governance. It now intends to do so.

Basis of consultation

The Consultation Paper focused on the Detailed Guidelines, which the FSC proposed:

1. are to be applied by insurance undertakings immediately; or, in the case of matters which are not currently required under Gibraltar legislation, but will be required when the Solvency II directive takes effect

2. guide an insurance undertaking so that it can take the necessary steps to ensure that it will meet the Guideline when the Solvency II directive takes effect.

Stakeholders were asked to consider the Guidelines set out in the FSC's draft Guidance Note, as well as the ultimate objective of these Guidelines, and to provide the FSC with any comment that they considered relevant.

Outcome of consultation and summary of responses received

The consultation period ended on 29 November 2013.

Five responses were received. These can be found on the following webpage

http://www.fsc.gi/firms/consultation.htm

Respondents were generally supportive of the Guidelines, noting that compliance with EIOPA Guidelines and strengthening of the industry's Corporate Governance framework should both have a positive impact.

A number of respondents asked for clarification as to which Guidelines fell into the first category, with immediate applicability, and which fell into the second category whereby firms would only need to take necessary steps for compliance when Solvency II takes effect. The FSC confirms that all Guidelines that are not marked as ("Solvency II Requirement") fall into the first category. To further assist users of the Guidance Note, the references have been changed slightly so that all Guidelines falling into the second category now have their own reference number. An appendix has been added listing the Guidelines that fall within the second category, and all Guidelines not listed in that Appendix then fall within the first category.

A number of respondents asked for clarification as to how the FSC expects to apply the principle of proportionality. The FSC acknowledges that this remains a key issue. The FSC is mindful of the principle that the duty to manage a business falls upon the senior management of that business, and that the Directors of an insurer, both executive and non-executive, have ultimate responsibility for ensuring that the business is properly run and operates in accordance with regulatory requirements, and we will be mindful of this principle where we are in a position to take a proportionate approach. The FSC has participated in a recent workshop hosted by EIOPA in which NCAs were asked to debate areas where proportionality might be applied. Further clarity is required on this concept to ensure that a harmonised approach is adopted across Europe. To date there is no such clarity and the FSC is not in a position to provide a definitive response. Prior to attending the EIOPA Workshop the FSC requested industry input to assist its thinking and would again encourage market practitioners to provide the FSC with their views on how proportionality might be considered either generally, or in the context of the nature, scale and complexity of their specific business.

A number of respondents commented that some of the Guidelines which are to be immediately applicable appear to go beyond what is currently expected from the FSC, or beyond what is required by legislation. One example given was that while it is accepted that there are requirements for controllers and managers of an insurance undertaking to be “fit and proper”, there is currently no legislative requirement on Boards to investigate this and to demonstrate this on an ongoing basis. The FSC acknowledges that there is no explicit legislative requirement on Boards to investigate the fitness and propriety of individuals. However, the FSC expects all Gibraltar insurers to have policies in place to ensure compliance with all relevant requirements set out in Gibraltar law and regulations. It is a legislative requirement that all directors, controllers, managers or main agents of an insurer are fit and proper to hold their respective positions, and it follows that the FSC would expect an insurer to have policies in place to ensure that this remains the case. The FSC acknowledges that the relevant policies are in place in most insurers but that they may not in all cases be documented to the level that is likely to be required when Solvency II is fully implemented. The FSC considers that the transitional period before full implementation should allow insurers sufficient time to ensure that any shortcomings in documentation are remedied, and that processes are put in place to ensure that the documentation remains current. The FSC’s primary concern will continue to be that insurers should be able to clearly articulate what is driving their business in fundamental areas including but not limited to underwriting, reinsurance and investment management.

A number of respondents commented that it appears to be inconsistent for the risk management policy (Guideline 2.14) to be a Solvency II requirement, yet other Guidelines which refer to the risk management policy (2.16, 2.19, 2.20, 2.21, 2.22) are immediate requirements. The FSC notes that although the existence of a Risk Management function is a Solvency II Requirement, the requirement to manage underwriting, reinsurance, asset liability management, investment risk and liquidity risk are all key disciplines within an insurer’s business. The FSC considers that should a Gibraltar insurer have inadequate systems of control of its business in any one of these key areas the FSC would not regard the insurer as carrying on its business in a sound and prudent manner.

One respondent asked for clarification as to what will be expected of firms when Solvency II comes into effect. The FSC is aware that EIOPA has been tasked with preparing detailed guidelines for when Solvency II has been fully implemented, and the FSC expects that EIOPA will consult on these guidelines ahead of full implementation of Solvency II, and so the FSC does not propose to make any comment on what will be expected of firms when Solvency II comes into effect.

One respondent suggested that the FSC should include further clarification as to how it intended to apply Guideline 2.23, which relates to Investment risk management, in practice. The respondent noted that with sophisticated investments it is necessary to obtain and use information from third parties, for example credit ratings, which then form part of the risk assessment. The FSC is aware that a “Joint Consultation Paper On Mechanistic references to credit ratings in the ESAs’ guidelines and recommendations” was published by the three European Supervisory Authorities, and that this is an area where supervisory best practice is still developing. The FSC notes that

Guideline 2.23 falls within the second category, where firms need to take necessary steps for compliance, and the FSC expects EIOPA to issue further guidance on this subject. The FSC is therefore not yet in a position to comment on this issue.

One respondent commented that Guideline 2.12 on Outsourcing of Key Functions only applies to key functions as set out in Guideline 2.3. The respondent considered that as Guideline 2.3 on Key Functions is a Solvency II requirement, any Guideline regarding their outsourcing should also not apply at the present time. The FSC accepts that it would be more appropriate that Guideline 2.12 should be a Solvency II requirement, and has amended the Guidance Note to reflect this. The FSC has also amended Guideline 2.12 to make it clear that this Guideline applies to all key functions that are outsourced, and not just those set out in Guideline 2.3. The FSC notes that Financial Services Guidance Note No. 2 on Outsourcing ("the Outsourcing Guidance Note") will continue to apply. The Outsourcing Guidance Note states that *"The regulated firm should conduct appropriate due diligence in selecting third party providers to ensure they have the ability, capacity and authorisation required by law to perform the outsourced activities, reliably and professionally".* Current examples of outsourcing seen in the Gibraltar industry would include the Internal Control (Compliance) Function being performed by Gibraltar insurance managers, and the Outsourcing Guidance Note also applies to other key functions that are outsourced, such as claims handling and reserving, investment management and administration services.

One respondent observed that there was an incomplete sentence at the end of Guideline 2.23. The FSC has removed the incomplete sentence, as it had been included in error.