

PEER REVIEW OF KEY FUNCTIONS: SUPERVISORY PRACTICES AND APPLICATION IN ASSESSING KEY FUNCTIONS

Executive Summary

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European Insurance and
Occupational Pensions Authority

EXECUTIVE SUMMARY

The main task of the European Insurance and Occupational Pensions Authority (EIOPA) is to enhance supervisory convergence, strengthen consumer protection and preserve financial stability.

In the context of enhancing supervisory convergence and in accordance with its mandate, EIOPA regularly conducts peer reviews, working closely with national competent authorities (NCAs), with the aim of strengthening both the convergence of supervisory practices across Europe and the capacity of NCAs to conduct high-quality and effective supervision.

In line with its mandate, the outcome of peer reviews, including identified best practices, are to be made public with the agreement of the NCAs that have been subject to the review. ⁽¹⁾

BACKGROUND AND OBJECTIVES

Enhancing the governance system of insurers ⁽²⁾ is one of the major goals of Solvency II (SII). The four key functions (risk management, actuarial, compliance and internal audit) as required under the SII regulation are an essential part of the system of governance. These key functions are expected to be operationally independent to ensure an effective and robust internal control environment within an insurer and support high quality of decision making by the management. At the same time it is also important that these governance requirements are not overly burdensome for small and medium-sized insurers. Therefore SII allows NCAs to apply the principle of proportionality in relation to compliance with key function holder requirements for those insurers.

Under SII, insurers may combine key functions in one holder. However, such combinations have to be justified by the principle of proportionality and insurers need to properly address the underlying conflicts of interest. Holding a key function should generally not be combined with administrative, management or supervisory body (AMSB) membership or with operational tasks because of their controlling objective. Thus, these combinations should rather occur in exceptional cases, taking into account a risk-based approach and the manner in which the insurer avoids and manages any potential conflict of interest.

This peer review assesses how NCAs supervise and determine whether an insurer's setting of key functions fulfils the legal requirements of SII with a particular emphasis on proportionality. The peer review examines practices regarding:

⁽¹⁾ <https://eiopa.europa.eu/regulation-supervision/common-supervisory-culture/peer-reviews>

⁽²⁾ In this report the term insurer refers to insurance or reinsurance undertakings as defined in Article 13 of the SII Directive.

- › combining key functions under one holder;
- › combining key functions with AMSB membership or with carrying out operational tasks;
- › subordination of one key function under another key function;
- › split of one key function among several holders;
- › assessment of the fitness of key function holders; and
- › outsourcing of key functions.

The period examined under the scope of this peer review was 2016 but also covered supervisory practices executed before 2016 in the preparatory stage of SII.

The peer review was conducted among NCAs from the European Economic Area (EEA) on the basis of EIOPA's Methodology for conducting Peer Reviews (Methodology).

Detailed information was gathered in the course of the review. All NCAs completed an initial questionnaire. This was followed by fieldwork comprising visits to 8 NCAs and 30 conference calls.

MAIN FINDINGS

The review showed that NCAs in general apply the principle of proportionality and that they have adopted similar approaches.

SUMMARY RESULTS OF THE COMPARATIVE ANALYSIS

- › **Supervisory framework:** Approximately half of NCAs use written supervisory guidance for the application of the principle of proportionality. Larger NCAs in particular use written supervisory guidance in order to ensure consistency of their supervisory practice among their supervisory staff (see 2.1).
- › **Approach of NCAs:** Most NCAs have a similar approach. NCAs assess the insurers' choice of key function holders at the time of initial notification regarding the key function holder's appointment. If any concerns are noted at this stage, for example regarding combinations or fitness, NCAs generally challenge and discuss these issues with the insurer, rather than issuing formal administrative decisions (see 2.2).
- › **Combining key functions in one holder:** This occurs in almost all countries. The most frequent combinations are between risk management and actuarial functions and between risk management and compliance functions. Combinations are most commonly used by smaller insurers but are also seen in large insurers. EIOPA has identified the need to draw the attention of NCAs to the need to challenge combinations more strongly, especially when they occur in bigger, more complex insurers, and to ensure that adequate mitigation measures are in place to warrant a robust system of governance (see 2.3).
- › **Holding the internal audit function and other key functions:** The combination of the internal audit function holder with other key functions occurs in 15 countries, although the frequency of such combinations is relatively low. Moreover, there were cases of the internal audit function holder also carrying out operational tasks which could lead to conflicts of interest and compromise the operational independence of the internal audit function. It is important to emphasise that the legal exemption of Article 271 of the Commission Delegated Regulation EU (2015/35) does not apply to the combination with operational tasks (see 2.4).

- **Combining a key function holder with AMSB membership:** Most NCAs follow a similar and comprehensive approach regarding the combination of key function holder and AMSB member. In this regard, NCAs accept such cases only if deemed justified under the principle of proportionality (see 2.5).³ This peer review shows that two NCAs request or support combinations of AMSB member and the risk management function holder regardless of the principle of proportionality in order to strengthen the knowledge and expertise regarding risk management within the AMSB.
- **Combining key function holders (excluding internal audit function holder) with operational tasks:** In nearly all countries combinations of risk management, actuarial and compliance key function holders with operational tasks occur, but such combinations generally occur rarely or occasionally (see 2.3.2). However, several NCAs do not have a full market overview of such combinations with operative tasks. Adequate mitigating measures are essential to reduce potential conflicts of interest when key function holders also carry out operational tasks. The most common combinations are the compliance function holder with legal director and the risk management function holder with finance director (see 2.6).
- **Splitting a key function between two holders:** About half of the NCAs reported cases where more than one individual is responsible for a particular key function ('split of key function holder'). The most common split concerns the actuarial function (split between life and non-life business). NCAs should monitor such splits in order to maintain appropriate responsibility and accountability among key function holders (see 2.7).
- **Subordination of a key function holder to another key function holder or head of operational department:** This is observed in half of the countries reviewed. An organisational subordination can be accepted, but there needs to be a direct 'un-filtered' reporting line from the subordinated key function holder to the AMSB. In cases of subordination, conflicts of interest have to be mitigated and operational independence needs to be ensured including the mitigating measures concerning the remuneration of the subordinated key function holders (see 2.8).
- **Fitness of key function holders:** Most NCAs assess the fitness of the key function holder at the time of initial notification and apply the principle of proportionality. Several NCAs did not systematically assess the key function holders appointed before 2016. These NCAs are advised to do so using a risk-based approach (see 2.9).
- **Outsourcing of key function holders:** Most NCAs have observed outsourcing of key function holders. According to the proportionality principle, an AMSB member may also be a designated person responsible for overseeing and monitoring the outsourced key function. Eight NCAs make a distinction between intra-group and extra-group outsourcing and six NCAs do not require a designated person in all cases, which may give rise to operational risks (see 2.10).

3 These cases occur rarely (less than 5% of the insurers) or occasionally (between 5% and 25% of the insurers).

Best practices

Through this peer review, EIOPA identified four best practices.

- When NCAs adopt a structured proportionate approach based on the nature, scale and complexity of the business of the insurer regarding their supervisory assessment of key function holders and combination of key function holders at the time of initial notification and on an ongoing basis. The best practice also includes supervisory documentation and consistent and uniform data submission requirements (for example an electronic data submission system for key function holder notification). This best practice has been identified in Ireland and the United Kingdom (see 2.2.2).
- When an NCA has a supervisory panel set up internally which discusses and advises supervisors about complex issues regarding the application of the proportionality principle in governance requirements regarding key functions. This best practice has been identified in the Netherlands (see 2.2.2).
- When assessing the combination of key function holder with AMSB member, EIOPA considers the following as best practice for NCAs:
 - To publicly disclose the NCA's expectations that controlling key functions should generally not be combined with operational functions for example with the membership of the AMSB. Where those cases occur, NCAs should clearly communicate their expectation that the undertaking ensures that it is aware of possible conflicts of interest arising from such a combination and manages them effectively.
 - To require from insurers that main responsibilities as a member of the AMSB do not lead to a conflict of interest with the tasks as a key function holder.
 - To assess whether the other AMSB members challenge the key function holder also being an AMSB member.

This best practice has been identified in Lithuania (see 2.5.3).

- When NCAs apply a risk-based approach for the ongoing supervision that gives the possibility to ensure the fulfilment of fitness requirements of KFHs at all times by holding meetings with key function holders on a regular scheduled basis as part of an NCA's work plan (annual review plan). The topics for discussion for those meetings can vary, depending for example on actual events and current topics. This best practice has been identified in Ireland and the United Kingdom (see 2.9.2).

These best practices provide guidance for a more systematic approach regarding the application of the principle of proportionality as well as for ensuring consistent and effective supervisory practice within NCAs.

OVERVIEW OF RECOMMENDED ACTIONS

The peer review also found that some NCAs had not yet assessed key functions according to SII requirements. Other NCAs had weaknesses, in particular regarding the depth of assessment and mitigating measures demanded from insurers for example in cases where combinations exist.

Based on the findings of the review, EIOPA has issued a number of recommended actions to NCAs (see 2.2 to 2.10). The table below provides an overview of the area of supervisory approaches of NCAs to which the specific recommended actions apply. Within each area, the recommended actions towards the NCAs are tailored to their specific situation.

Area of recommended actions	NCA(s) concerned
SUPERVISORY APPROACH OF NCAS	
NCAs should develop and implement adequate supervisory procedures and criteria to assess governance requirements regarding key functions in a risk-based supervisory framework according to Article 29 of the SII Directive; this especially applies to the proportionality principle laid down in Article 41 of the SII Directive, followed by amongst others Article 42 of the SII Directive and the Articles 258 and 269 of the Commission Delegated Regulations EU (2015/35).	<ul style="list-style-type: none"> ■ Financial Supervision Commission (Bulgaria), ■ Cyprus Insurance Companies Control (Cyprus), ■ Bank of Greece (Greece), ■ Fjármálaeftirlitið Financial Supervisory Authority (Iceland), ■ Autoridade de Supervisão de Seguros e Fundos de Pensões (Portugal), ■ Dirección General de Seguros y Fondos de Pensiones (Spain)
The NCA should require all (re)insurers to have in place an effective system of governance which provides for sound and prudent management of the business.	<ul style="list-style-type: none"> ■ Fjármálaeftirlitið Financial Supervisory Authority (Iceland)
The NCA should take into account nature, scale and complexity when applying the proportionality principle in general (not only or mainly for insurers with market share up to 1%, as this threshold is too low).	<ul style="list-style-type: none"> ■ Komisja Nadzoru Finansowego (Poland)
COMBINATIONS WITH KEY FUNCTION HOLDERS OTHER THAN INTERNAL AUDIT	
NCAs should increase the monitoring process of combinations between key function holders and the knowledge of the situation in the national market and assess whether combinations of key functions fulfil the necessary conditions in relation to fitness and independence in the insurer's organisation structure.	<ul style="list-style-type: none"> ■ Financial Supervision Commission (Bulgaria), ■ Finanstilsynet (Denmark), ■ Financial Supervision Authority (Estonia), ■ National Bank of Slovakia (Slovakia)
In the situation where the actuarial function fulfils tasks in the remit of the risk management function. NCAs should assess conflicts of interest.	<ul style="list-style-type: none"> ■ Czech National Bank (Czech Republic)
COMBINATION OF THE INTERNAL AUDIT FUNCTION HOLDER WITH OTHER KEY FUNCTION HOLDERS	
NCAs should increase the monitoring process of combinations between internal audit key function and other key functions, as well as the knowledge of the situation in the national market and assess whether combinations of these key functions fulfil the necessary conditions in relation to fitness and independence in the insurer's organisation structure.	<ul style="list-style-type: none"> ■ Financial Supervision Commission (Bulgaria), ■ Finanstilsynet (Denmark), ■ Financial Supervision Authority (Estonia), ■ Autoridade de Supervisão de Seguros e Fundos de Pensões (Portugal)
The NCA should take proper measures to ensure that insurers are compliant with Article 271 of the Commission Delegated Regulation EU (2015/35) and internal audit function is not combined with operational functions.	<ul style="list-style-type: none"> ■ Commissariat aux assurances (Luxembourg)
COMBINATIONS OF KEY FUNCTION HOLDERS AND AMSB MEMBERS	
NCAs should assess whether combinations of key functions with AMSB membership fulfil the necessary conditions in relation to independence in the insurer's organisation structure.	<ul style="list-style-type: none"> ■ Financial Supervision Commission (Bulgaria), ■ Commissariat aux assurances (Luxembourg), ■ Autoridade de Supervisão de Seguros e Fundos de Pensões (Portugal), ■ National Bank of Slovakia (Slovakia)

Area of recommended actions	NCA(s) concerned
NCA should pay attention to that the key function holder who is as well member of the (executive) AMSB, is effectively able to accomplish its controlling responsibilities in an objective manner which is independent from the operational management of the business (e.g. no combination of responsibility for asset management and risk management function holder). It should be verified that insurers have implemented internal measures and procedures to mitigate conflicts of interest and to ensure that the AMSB (as a whole without the AMSB member who is as well the key function holder) can effectively challenge the key function holder. EIOPA acknowledges that some NCAs request and support such combinations for the key function holder on risk management in order to ensure that the AMSB possesses suitable knowledge of risk management.	<ul style="list-style-type: none"> ■ National Bank of Belgium (Belgium), ■ Czech National Bank (Czech Republic)
COMBINATIONS OF KEY FUNCTION HOLDERS WITH OPERATIONAL TASKS	
NCA should increase the monitoring process of combinations of key function holders and operational tasks and the knowledge of the situation in their national market and assess whether combinations of key functions fulfil the necessary conditions in relation to independence in the insurer's organisational structure.	<ul style="list-style-type: none"> ■ Financial Supervision Commission (Bulgaria), ■ Financial Supervision Authority (Estonia), ■ Malta Financial Services Authority (Malta), ■ National Bank of Slovakia (Slovakia)
SUBORDINATION OF A KEY FUNCTION HOLDER TO ANOTHER KEY FUNCTION HOLDER OR HEAD OF OPERATIONAL DEPARTMENT	
NCA to guarantee the independence of the key function holders including a direct reporting line to the AMSB.	<ul style="list-style-type: none"> ■ National Bank of Belgium (Belgium), ■ Financial Supervision Authority (Estonia), ■ Bank of Greece (Greece), ■ Finanstilsynet (Norway), ■ National Bank of Slovakia (Slovakia)
FITNESS OF KEY FUNCTION HOLDERS	
The NCA should also carry out fitness assessments for key function holders other than actuarial function holders.	<ul style="list-style-type: none"> ■ Commissariat aux assurances (Luxembourg)
The NCA should assess the fitness of key function holders after having received the notification of the key function holder's appointment whereby a risk-based approach can be used.	<ul style="list-style-type: none"> ■ De Nederlandsche Bank (the Netherlands)
The NCA should complete fit (and propriety) assessments for all key function holders.	<ul style="list-style-type: none"> ■ Autoridade de Supervisão de Seguros e Fundos de Pensões (Portugal)
OUTSOURCING	
NCA should apply Guideline 14 of EIOPA's Guidelines on system of governance (as well as Article 49 SII Directive and Article 274 of the Commission Delegated Regulation EU (2015/35)) in a proportionate manner.	<ul style="list-style-type: none"> ■ Financial Supervision Commission (Bulgaria), ■ Insurance Supervision Agency (Slovenia)
The NCA should improve its knowledge of the market and assess and challenge insurers regarding their outsourcing practices.	<ul style="list-style-type: none"> ■ FIN-FSA (Finland)

The issues and corresponding recommended actions identified through this peer review give rise to a more consistent approach to supervision of the application of the principle of proportionality. In addition, several NCAs have already provided evidence of improvements made to their supervisory practices that have resulted from this peer review. Note that these improvements are not considered in this report since their implementation date is after the review's reference period. They will however be taken into consideration in the follow-up of the peer review.

IMPACT ON THE CREATION OF A COMMON SUPERVISORY CULTURE

Building a common supervisory culture is a fundamental task for EIOPA to ensure the development of high-quality, effective and consistent supervision across the European Union. Regular, open dialogue and exchanges of experience between national supervisors and EIOPA is essential so that supervisors can learn from each other and enhance supervision.

This peer review has made a direct contribution to fostering a common supervisory culture at the European level (see 2).

This peer review has resulted in a comprehensive overview of the insurance market and supervisory practices of NCAs in the European Economic Area (EEA) covering many issues related to key functions and key function holders. NCAs are now able to compare their supervisory approaches against those of peer NCAs. Such an overview is the basis for coherent and high quality supervision within the EEA.

EIOPA also shared some observations with NCAs stemming from additional findings made in the course of analysing NCA practices to support NCAs to further develop their supervisory practices. An example of such an observation is to obtain a better market overview by improving the supervisory databases regarding the appointments and roles of key function holders. These observations are directly related to this peer review although they were not qualified as recommended actions according to the Methodology.

The peer review process led not only to discussions within NCAs but also between NCAs. Through examining different practices and sharing experiences, the peer review has led to a better awareness of this important supervisory issue among NCAs.

FOLLOW UP AND NEXT STEPS

EIOPA will consider the outcome of this peer review in a revision of its Guideline 14 on system of governance, in which a distinction between intra- and extra-group outsourcing taking into account the proportionality principle could be made. In addition, EIOPA will consider how to best reflect the overall results (findings, best practices, recommended actions and observations) of this peer review in its work on the supervisory review process (SRP).

As follow-up of this peer review, NCAs' compliance with the recommended actions will be assessed as foreseen in the Methodology.

The overview of the market facts and of supervisory practices provides a sound basis for improving supervisory practices, using also formal decisions where appropriate, and for more consistent supervisory approaches within the EEA, which is essential for creating a level-playing field within the common market.

**EUROPEAN INSURANCE AND
OCCUPATIONAL PENSIONS AUTHORITY**

Westhafenplatz 1,
60327 Frankfurt am Main, Germany



Publications Office

PDF	ISBN 978-92-9473-106-7	doi:10.2854/239103	El-o6-18-215-EN-N
Print	ISBN 978-92-9473-107-4	doi:10.2854/495348	El-o6-18-215-EN-C