



IAIS

INTERNATIONAL ASSOCIATION OF
INSURANCE SUPERVISORS

Public

Draft Application Paper on Proactive Supervision of Corporate Governance

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About the IAIS

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organisation of insurance supervisors and regulators from more than 200 jurisdictions. The mission of the IAIS is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

Established in 1994, the IAIS is the international standard setting body responsible for developing principles, standards and other supporting material for the supervision of the insurance sector and assisting in their implementation. The IAIS also provides a forum for Members to share their experiences and understanding of insurance supervision and insurance markets.

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Application Papers provide additional material related to one or more ICPs, ComFrame or G-SII policy measures, including actual examples or case studies that help practical application of supervisory material. Application Papers could be provided in circumstances where the practical application of principles and standards may vary or where their interpretation and implementation may pose challenges. Application Papers can provide further advice, illustrations, recommendations or examples of good practice to supervisors on how supervisory material may be implemented.

International Association of Insurance Supervisors c/o Bank for International Settlements
CH-4002 Basel
Switzerland
Tel: +41 61 280 8090
Fax: +41 61 280 9151
www.iaisweb.org

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Introduction

1. The outcome of the IAIS Self-Assessment and Peer Review (SAPR) conducted in 2014 highlighted the most common challenges to observance of Insurance Core Principles (ICP) 7 Corporate Governance and 8 Risk Management and Internal Controls and underlined the need for additional guidance on supervisory practices related to corporate governance that are proactive and sufficiently robust. While some of the issues identified in the SAPR were addressed by revisions to ICP 7¹, the IAIS also noted that some challenges related to proactive supervision of corporate governance should be addressed by providing supervisors with good practices and tools.

2. Proactive supervision requires a supervisor to be forward-looking, to identify issues early, and to act quickly and constructively to address circumstances that are not yet critical but could lead to corporate governance-related problems, adverse outcomes to policyholders or to violations of local requirements or laws. Proactive supervision may be contrasted with reactive supervision, which responds after a problem has occurred, or supervisory forbearance, in which a supervisor does not take – or is reluctant to take – early corrective action.

3. Proactiveness has been recognised as a key feature of successful supervision². According to ICP 9.7.1, the supervisor should be proactive and forward-looking in conducting effective off-site monitoring, and not rely only on historical data. The supervisor should question an individual insurer's or the entire sector's directions or actions, in good as well as bad times, and not act only after things have gone awry.

4. This Application Paper supports the practical application of the corporate governance-related ICPs, mainly ICP 7 and ICP 8. It is based on inputs from members of the Governance Working Group and feedback received from the broader IAIS membership and stakeholders.

5. This Application Paper sets out good practices related to the organisation and functioning of the supervisor, with the objective of promoting proactive supervision of corporate governance. It aims to raise awareness of, and seeks to address, the organisational, cultural, and procedural challenges faced by supervisors in detecting problems in corporate governance and taking appropriate steps at an early stage.

6. This Application Paper recognises that there is no one-size-fits-all approach to proactive supervision. There are different steps that supervisors may decide to take, both organisational and procedural, direct and indirect, separately or together, to foster proactiveness. Whichever steps are taken, proactive supervision should be carried out proportionately to the issues identified, using an approach customised to the circumstances, including relevant supervisory objectives, laws and regulations. Whether the supervisor has or should have certain legal powers to foster proactive supervision is outside the scope of this Application Paper. Also external developments, which are outside the control and influence of the supervisor, fall outside the scope of this Application Paper.

¹ Finalised in November 2015.

² See e.g. J. Viñals and J. Fiechter, et al., *The Making of Good Supervision: Learning to Say "No"*, IMF Staff Position Note, SPN/10/08, May 2010, p. 19. See also Basel Committee on Banking Supervision (BCBS), *Frameworks for early supervisory intervention*, March 2018. <https://www.bis.org/bcbs/publ/d439.pdf>.

7. Throughout this Application Paper, the term "supervisor" is used to indicate the authority supervising insurers, while "the management team" refers to the management of the supervisor and the term "staff" refers to the persons conducting the supervision for the supervisor.

8. This Application Paper is organised around four sections that address key aspects of fostering and supporting proactive supervision. Section 1 discusses how the supervisor's own organisation, culture and process should support proactive supervision. This encompasses the supervisor itself, as well as its management team and staff. Section 2 highlights that the supervisor needs relevant and timely information in order to be proactive. Section 3 provides a non-exhaustive list of early warning indicators – yellow and red flags – that may signal the need for investigation and, potentially, further action. Finally, Section 4 explains how effective communication by the supervisor with both insurers and the wider public can promote proactive supervision.

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1 Supervisory organisation, culture and processes

9. Supervisory forbearance, in which supervisors do not take – or are reluctant to take – early corrective action, has been identified as a significant obstacle to proactive supervision³. To counter institutional tendencies towards forbearance, supervisors should have an appropriate supervisory framework, supported by experienced staff, and adequate internal organisation, culture, and processes.

10. This section identifies some challenges to the supervisors' organisation, culture and processes, including the ability and willingness of staff, in carrying out proactive supervision of corporate governance, and proposes good practices to address those challenges.

11. The good practices outlined below complement those in ICP 2, which describes how the supervisor, in the exercise of its responsibilities and powers, is operationally independent, accountable and transparent; and has adequate resources and internal governance arrangements.

1.1 Supervision of financially sound insurers

12. Supervisors may be faced with a dilemma when conducting more intensive supervision of corporate governance, especially in supervising financially sound insurers. The insurer may highlight its financial achievements as evidence of the insurer's sound operations. Hence, it may be difficult to justify the allocation of resources to supervision of corporate governance of such insurers, especially when taking a risk-based approach to supervision.

13. An insurer's financial condition may provide insights into its financial capability and strength. A good financial condition, however is not a direct indication of sound corporate governance, as weaknesses in an insurer's corporate governance arrangements may only come to light over the medium or long term.

14. To be proactive, supervisors should consider the following practices, among other measures:

- Introduce procedures to look more deeply into certain aspects of an insurer's corporate governance even when the insurer has a positive financial situation. For example, the supervisor could use yellow and red flags or other internal scoring system to help identify issues that may merit further attention, according to the scale or nature of the risk⁴.
- Trigger additional review when there is a diversity of opinions within the supervisor. Different perspectives and views on a potentially problematic situation may promote prevention of risks building up and/or early supervisory steps. The management team could also encourage the staff to present divergent views throughout the discussion of supervisory findings.

³ BCBS, *Frameworks for early supervisory intervention*, p. 21.

⁴ See Section 3 "Yellow and red flags" for further details.

1.2 Supervisory expertise

15. Supervisors should have staff equipped with the analytical and technical skills needed to analyse corporate governance information from insurers and draw appropriate conclusions.

16. All relevant staff should receive regular training on corporate governance. Supervisors should offer comprehensive introductory training for new staff, in addition to regular training for all staff. Such training may include not only the corporate governance requirements applicable in their jurisdiction, but also the latest developments and good practices from other jurisdictions, other sectors or academics.

17. More experienced staff could be paired with less experienced staff and/or more experienced staff could be encouraged to formally or informally coach or train less experienced supervisors, so that all staff have sufficient skills to carry out proactive supervision.

18. Information and experiences on corporate governance should be exchanged regularly between teams or units within the supervisor. For example, for larger insurers which have assigned supervisory teams, senior staff and/or corporate governance subject matter experts could schedule regular sessions with the supervisory teams to discuss corporate governance issues. Senior staff or corporate governance subject matter experts should also review the supervisory teams' reports and specifically flag questions or share potential issues relating to corporate governance.

1.3 Supervisory “blind spot”

19. Supervisors – at both the staff level and the institutional level – may develop “blind spots” over time from continuous supervision of the same insurer. Methods to remedy or minimise such “blind spots” include:

- Having multiple staff members review each insurer (the so-called “4-eye” or “6-eye” principle) through supervisory partnerships (for example, placing two staff members in charge of the same insurer). Such partnerships may be particularly useful in the context of group supervision, where one staff member could be in charge of the group's supervision and the other in charge of supervising the insurance legal entity within the group;
- Rotating the insurer portfolio of staff on a periodic basis (for example, every three years), both to prevent staff from becoming overly familiar with their assigned insurers, and thus blind to issues which may arise, and also to broaden staff's experience by regularly exposing them to other insurers;
- Having dedicated governance experts identify, and help staff responsible for their assigned insurers address, emerging corporate governance issues; and
- Having feedback loops with other supervisory units (such as special investigation or intervention units) who may identify concerns with an insurer's corporate governance.

1.4 Willingness to act

20. A supervisor may face challenges in ensuring its staff are willing to act when potential problems begin to appear. To counteract this issue, the supervisor should express strong and frequent support for taking early supervisory steps.

21. Specific measures may vary depending upon the circumstances inhibiting staff's willingness to act. Three scenarios, and possible solutions, are described below.

22. Staff may be reluctant to act upon their findings or conclusions and escalate an issue, because of fear that the insurer's problems will be perceived as a result of their personal failure to supervise the insurer adequately. To address this issue, supervisors should circulate internally on a regular basis peer grouping exercises that allow staff to compare and benchmark findings in similar cases. This will facilitate consistency across the supervisor in terms of actions and approaches taken, giving at the same time proper consideration to circumstances of a particular case.

23. Staff may be unwilling to act because they do not want to appear to be managing the insurer. To address this concern, the management team could practice an "open door policy" and otherwise promote an open culture where staff are not afraid, when in doubt about an insurer's corporate governance practices, to discuss or escalate issues to the management team.

24. Staff may fear repercussions if supervisory investigation does not result in additional adverse findings. To counteract this fear, supervisors should, in addition to the "open door policy" mentioned above, promote a culture of tolerance for staff who raise potential issues, even where that issue may not materialise or rise to the level of a significant risk. Staff should feel open to be seen as making mistakes and not incur repercussions to their career.

1.5 Organisational impediments

25. A supervisor's own organisation, culture and processes may impede proactive supervision. For example, the supervisor may have information that would allow identification of potential issues at an early stage, but that information may be held by a staff member or unit within the supervisor without the necessary authority.

26. A supervisor should consider creating appropriate support structures to encourage taking early supervisory steps. Such support structures could include:

- dedicated staff;
- special investigation or intervention units⁵;
- a legal unit, which could provide advice and help to identify gaps in the existing legal framework that may hinder taking early supervisory steps or restrict the capacity to intervene.

27. A supervisor should consider instituting internal processes that promote taking early supervisory steps, such as:

- Clearly delegating responsibilities from the management team to staff;

⁵ See paragraph 19.

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- Routinely sharing information between staff and the management team, as well as within the supervisory teams and between different supervisory teams;
 - Encouraging staff to raise concerns with the management team if their analysis suggests a potential material adverse finding⁶ or other threats to the insurer's financial soundness over the short or medium term;
 - Instituting a process to transfer specific issues to a dedicated supervisory or enforcement team when an insurer persistently is not cooperating;
 - Classifying recommendations according to the importance and degree of urgency of expected corrective measures based on a progressive scale of requirements (e.g. supervisory intervention ladder), established by the supervisor;
 - Requesting internal audit focus on the escalation process within the supervisor; and/or
 - Conducting thematic reviews within the supervisor to analyse the extent to which corporate governance is scrutinised.

⁶ NAIC explanation: "For example, a "material adverse finding" is a finding made by a department with respect to an event, trend, transaction or series of transactions, fluctuation, agreement, arrangement, operating results or violation of law, which either has, or reasonably could have, a significant negative impact on a company's financial position."

2 Information

28. Supervisors may encounter challenges obtaining information, such as resistance from an insurer in providing adequate information in a timely manner or complaints about overly burdensome information requests. However, the supervisor needs to have relevant and timely information to proactively identify potential corporate governance-related issues and to carry out proactive supervision.

29. Supervisors should be able and willing to gather both quantitative and qualitative information from different sources on the corporate governance-related issues facing the insurer and the insurer's ability to address them.

30. Supervisors should consider a range of approaches to gathering relevant information in order to facilitate the early identification of corporate governance-related problems that require proactive supervisory steps, such as the following:

- Information gathered from the insurer itself, including its reports and meetings with the insurer;
- Thematic reviews and analysis. These may help identify potential outliers which, in turn, may require further investigation by the supervisor. They may also help in the identification of emerging issues;
- Obtaining information from other supervisors (e.g. within supervisory colleges, during bilateral meetings or through reports from on-site inspections) ;
- Market-wide reports such as analysis of the industry and by rating agencies as well as other market intelligence;
- Consumer or whistle-blowing complaints. These may provide insights into possible corporate governance issues in the insurer as well as possible misconduct; and
- Meetings between the supervisors and external and internal auditors. These may highlight the potential lapses in the insurer's control environment and point to weaknesses in corporate governance.

31. When gathering and assessing corporate governance-related issues, supervisors should consider the following:

- How to evaluate the corporate culture within the insurer, not only at the Board and Senior Management levels, but also within the business lines;
- How to assess whether remuneration and other staff incentives align with the insurer's corporate governance values and with the insurer's strategic priorities set by the Board and Senior Management; and
- How to assess whether the Board and Senior Management of the insurer exercise adequate oversight on the insurer's business practices including customer acquisition activities and differences in risks arising from various distribution methods and channels.

3 Yellow and red flags

32. In order to be able to identify corporate governance-related problems at an early stage, the supervisor should consider developing an early warning system of potential indicators. This may assist the supervisor to identify significant changes, anomalies or trends in order to respond in a timely manner. Those indicators could take the form of “yellow or red flags”.

33. An early warning system should include recommendations on possible next steps after yellow or red flags are identified. And the supervisor’s response to a yellow or red flag should take into account all available information and be determined on a case-by-case basis.

34. Identification of a yellow or red flag may indicate a broader corporate governance-related issue and the supervisor should endeavour to identify and assess the underlying issue. The supervisor should take into account the nature of the yellow or red flag identified; for some of them, a single occurrence may be a cause for concern itself whereas for others, the supervisor may be looking for a recurring pattern.

35. The following non-exhaustive list of examples of non-financial yellow and red flags may indicate problems related to corporate governance:

- Policies and procedures:
 - Inconsistencies and/or gaps in internal control policies, audits and reporting (i) within the insurance legal entity or (ii) between the group and insurance legal entities;
 - Failure of the insurer to conduct business and fulfil obligations in accordance with written procedures (e.g. compliance with by-laws, charters or internal guidelines);
 - Lack of a transparent mechanism to take disciplinary actions;
 - Inadequate disciplinary response to infractions;
 - Inadequate handling by the insurer of employee or customer complaints related to corporate governance;
 - Lack of a process or having an inadequate process to, identify, evaluate or escalate risk or corporate governance issues;
 - Lack of a whistle-blowing process or not having an effective whistle-blowing process;
 - Lack of sufficient information flow within the insurer; and
 - Lack of staff training on topics such as internal control policies and procedures; compliance with laws and regulations; whistleblowing process; escalation of risks, non-compliance and misconduct issues.
- Board, Senior Management and Key Persons in Control Functions:
 - The insurer appoints or proposes to appoint members of the Board, Senior Management or Key Persons in Control Functions who do not possess the necessary suitability;
 - High or frequent turn-over of the members of the Board, Senior Management or Key Persons in Control Functions;

- Sudden departures of the members of the Board, Senior Management or Key Persons in Control Functions;
- The Board or Senior Management overriding or ignoring existing policies and procedures (e.g. code of conduct, conflict of interest);
- The Board or Senior Management are unaware of or unable to articulate their own responsibilities or those of their committees;
- The Board or Senior Management do not use available information when making decisions;
- Inability of the Board or Senior Management to clearly explain the strategy, risks and results to the supervisor;
- Lack of awareness by the Board or Senior Management of the culture within the insurer;
- Inconsistency between the culture promoted by the Board and the culture within the insurer;
- Lack of adequate responses from the Board and Senior Management to developments affecting the insurer;
- No issues are escalated to the Senior Management and/or to the Board; and
- Remuneration of Senior Management, Key Persons in Control Functions or major risk-taking staff is not commensurate with their key performance indicators and not in line with the insurer's business and risk strategies or long-term interest of the insurer.
- Board committees:
 - Lack of effective delegation from the Board to Board committees;
 - Inappropriate composition of Board committees (for example, members without adequate expertise or sufficient independence); and
 - Lack of effective lines of reporting to Board committees.
- Control functions:
 - Control functions are not adequately resourced (e.g. too few people compared to the size of the company and volume of operations);
 - Lack of independence of control functions, in particular a lack of separation from business functions;
 - The head of a control function does not have access to the Board;
 - The head of the control function's records are non-existent or of poor quality;
 - The scope and frequency of internal audit are inadequate; and
 - Internal audit recommendations do not align with the internal audit findings.
- Other indicators:
 - Non-compliance with regulatory requirements;
 - Recurring findings observed by internal or external auditors or supervisors (i.e. repeated failure to resolve observed issues);

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- Lack of cooperation of the insurer with the supervisor;
 - Undue interference of an owner or another person in the insurer's operations;
 - Complaints received are above the norm for similar insurers; and
 - Whistle-blowing cases are above the norm for similar insurers⁷.

36. In addition, there can be financial indicators of governance-related problems, such as a significant financial loss, or adverse change to an insurer's balance sheet or level of capital cover, that:

- is out of line with the experience of the insurer's peers,
- was not anticipated or planned for by the insurer's Board and Senior Management, or
- which attracts significant adverse market comment or reaction (e.g. in the insurer's share price).

⁷ However, it is important to note that this disparity does not necessarily reflect poor corporate governance, but may be an indication of insurers having appropriate internal procedures that assist the staff with concerns to blow the whistle.

4 Communication

37. Effective communication with insurers and the wider public is one of the elements supporting proactive supervision of corporate governance⁸. Supervisors should share with insurers and the wider public the objectives and strategy of supervision and principles which guide their supervisory approach in order to increase the awareness and understanding by insurers and the wider public. A better understanding of the supervisory objectives may facilitate the furnishing of relevant information to the supervisor. In addition, it may promote more open and transparent dialogue between the supervisor and the insurer.

38. Communication by supervisors may encourage the industry to take actions or implement practices aimed at improving corporate governance, or prevent behaviour which may lead to improper corporate governance-related practices. For example, communication of the outcomes from a thematic review could help drive changes in behaviour that improve corporate governance.

39. Communication by supervisors may be verbal (e.g. physical meetings, public speeches) or written (e.g. publicly available reports, guidelines, policy statements). Such communication can be directed to the entire industry or selected insurers facing the same issues.

⁸ See draft revised ICP 2.9, available [here](#).

5 Conclusions

40. This Application Paper has been developed to provide good practices related to organisation and functioning of the supervisor, aimed at facilitating proactive supervision of corporate governance-related issues.

41. As indicated in this Application Paper, proactive supervision requires a supervisor to be forward-looking, to identify issues early, and act quickly and constructively to address circumstances that are not yet critical but could lead to corporate governance-related problems, adverse outcomes to policyholders or to violations of local requirements or laws. It seeks to address the challenges faced by supervisors in detecting problems in corporate governance and taking appropriate steps at an early stage.

42. To help provide a better understanding of proactive supervision of corporate governance-related issues, this Application Paper highlighted the following:

- Proactive supervision of corporate governance should be carried out proportionately to the issues identified and using an approach customised to the circumstances;
- There are different approaches to foster proactiveness of supervision of corporate governance;
- The supervisor should consider possible ways to improve the supervisory organisation, culture and processes, such as the expertise of the staff and their willingness to act upon relevant findings;
- The supervisor needs to have relevant information to be able to carry out proactive supervision and may consider a range of approaches to gathering such information;
- The supervisor should consider developing an early warning system of potential corporate governance-related indicators, such as the use of yellow and red flags; and
- Effective communication with insurers and the wider public supports proactive supervision of corporate governance.