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The implementation of new governance rules in the insurance sector: overview and outlook

ACPR

BANQUE DE FRANCE

CONTENTS

Introduction

Since 2015, the governance rules applicable to institutions supervised by the *Autorité de contrôle prudentiel et de résolution* (ACPR, Prudential Supervision and Resolution Authority) have been radically transformed. Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), which came into force on 1 January 2016, set down a precise, detailed framework for the organisation and operations of the governing bodies of insurance undertakings.

At the same time, the European regulatory authorities published associated guidance and legislation that aimed to clarify supervisors' expectations.

The purpose of this publication is thus to look back on these changes and to present the ACPR's assessment of these developments five years after the new rules came into force.

The findings are based on an analysis of an extensive body of documentation collected from the supervised institutions concerned and on interviews held with their executives and control function heads and with members of their supervisory bodies (chair of the board of directors and/or president of the risk committee). The methodology applied is set out in the appendix to this publication.

The intention of this review is not to provide a comprehensive and detailed inventory of all regulatory provisions concerning the governance of insurance undertakings under European and French law. Its objective is rather to highlight where the new rules depart most significantly from previous provisions and to draw attention to insurance undertakings' efforts to comply with them. It also serves – based on real cases dealt with by the ACPR – as a platform to recommend sound practices to help supervised entities improve their governance frameworks.

The key takeaways of this report are as follows.

- The new regulatory framework for governance is laid down in a directive that is binding on all European insurers irrespective of the legal and cultural environment in which they undertake their business activities. Nonetheless, in this respect, conditions differ greatly from one European Union (EU) Member State to another. Furthermore, the diversity that can be seen at the European level also exists within the French market. The profiles of the undertakings supervised by the ACPR thus differ greatly in terms of their size, activities and the legal texts that govern them (the French Insurance Code, Mutual Insurance Code or Social Security Code).

- The principle of proportionality is particularly relevant to issues of governance. While governance regulations and sound practices concern all institutions, they take on particular importance for large or complex groups. The ACPR therefore expects the largest groups, whether they are a publicly listed company or in the mutual insurance or provident institutions sectors, to follow the highest and most exacting market standards when choosing their governance system.

- The prudential regulations stress the supervisory body's new risk management duties, which have been expanded and reinforced considerably. However, it is important to remember that these new responsibilities take nothing away from the essential role the boards of directors and supervisory boards must continue to play in setting a firm's strategic orientations and taking the management decisions that fall within their remit (the scale of this role varies depending on the company's form).

- The segregation of duties between the chair of the board of directors and a company's managing director is sound governance practice and is becoming increasingly common in major firms. While this segregation is mandatory in the European banking sector, there are no formal regulations in the insurance sector that prohibit "dual hatting" (i.e. serving in more than one role) as managing director and chair of the supervisory body. Thus, even though the principle of segregation is laid down in international and European guidance, not all EU Member States, including France, have made it a regulatory requirement.

- In the absence of binding texts, the ACPR recommends segregation to all the undertakings under its supervision and expects it to be the norm in listed companies and large insurance groups. Segregation should therefore be implemented at head of group level and irrespective of legal form: *société anonyme* (SA, public limited company), *société d'assurance mutuelle* (SAM, mutual insurer), *union mutualiste de groupe* (UMG, mutual insurance union groups), *société de groupe d'assurance de protection sociale* (SGAPS, group social protection insurance companies) or *société de groupe d'assurance mutuelle* (SGAM, group mutual insurance companies).

- The regulatory provisions of the *Code de la mutualité* (the French Mutual Insurance Code) even make dual hatting unavoidable insofar as the chair of the board of directors is the effective manager by right. While the historical and cultural reasons behind this situation are understandable, it has to be acknowledged that it does not help prudential groups of entities subject to different codes to effectively and optimally organise their governance systems. The ACPR feels that on this point, the regulations need to be adjusted.

- The regulations stress the importance of criteria of experience and expertise in selecting directors and members of supervisory bodies as well as the people who effectively run the firm ("effective managers") and key function holders. When the supervisor deems that the professional experience of a candidate for an executive position is insufficient or inappropriate, it opposes the appointment or makes it conditional on the candidate following a supplementary training programme. For members of the supervisory body, the criterion applied is that of collective expertise. The effectiveness of an insurance undertaking's governance system largely depends on the manner in which the supervisory body plays its role. For example, it will be better prepared to take decisions that fall within its remit if its members have a sound understanding of the firm's business lines and of the regulations. Equally, it will better perform its duties if the members have the legitimacy that a transparent selection process carried out in a general meeting to approve their appointment would confer upon them. In practice, however, there is no definition of an optimal level of collective expertise for the supervisory body, nor is there an objective way to assess the legitimacy of its members. Because these considerations depend on an undertaking's corporate form, business activities and operating methods, the supervisor has not insisted on enforceable standards in this regard. However, it does expect supervised undertakings to establish their objectives and the means to achieve them and to decide how they intend to organise and formalise the process of selection, appointment and training of their directors.

- Compliance is required with the procedures stipulated in the regulations for governing bodies' approval of written policies, risk appetite, the ORSA (Own Risk and Solvency Assessment) and reports by key function holders. However, this compliance must not be purely formal. Decisions taken on risk management are binding and consequently should be made by the board of directors or the supervisory board after a proper discussion and after hearing from the people who effectively run the firm. It is vital that the supervisory body forms its own opinion and weighs the real stakes for the firm of the orientations it adopts.

- Many undertakings (mutual insurers governed by the French Mutual Insurance Code, provident institutions or SAMs) have committed to processes of closer cooperation and mergers to cope with the burgeoning competition and to improve their competitiveness. They need to reach critical mass on their markets and to that end have built up prudential groups (UMGs, SGAMs and SGAPSs). While maintaining a certain degree of autonomy, the affiliated entities within these groups aim to gradually streamline and integrate their information and management systems as well as the human resources those systems depend on.

An effective and properly functioning governance system is a key factor in the success of these prudential groups. However, they face numerous challenges due to their often complex organisation. A balance has to be achieved between requirements that may appear contradictory. In order to carry out the restructuring required, the decision-making bodies of these new groups must have sufficient legitimacy and authority. However, the governance structures of all the entities within the group must also fully play their part and be involved in setting strategies, policies and objectives as they are bound by the orientations adopted by the group. They must adhere to them while (at the level of the entity under their management) continuing to carry out the duties that fall within their remit.

Consequently, the choice of governance system by these prudential groups is a major issue. It must comply with the requirements of the prudential regulatory framework while also helping to bind together the different components of the new group. This is why the measures to be adopted to comply with the regulations must be subject to a thorough analysis in close consultation with the ACPR.

Governance: the main developments after the 2008 financial crisis

The three following points in particular will be discussed in this report:

- the role and composition of the supervisory body (the board of directors, the supervisory board or other body with similar duties);
- a more precise definition of executive functions; and
- strengthening the internal control and risk management functions.

1 The role and composition of the supervisory body

The entry into force of Solvency II significantly stepped up the requirements concerning the role and composition of the supervisory body (i.e. the board of directors, the supervisory board or other body with similar duties) and tasked the supervisor with verifying that these rules had been properly implemented.

In addition to the duties, such as appointing managers or revoking their mandates or overseeing the management of the undertaking concerned, imposed by the French Commercial Code or by other legislation governing entities other than trading companies (the French Mutual Insurance Code, for example) the supervisory body was also charged with specific duties under the regulations applicable to the insurance sector.

Consequently, the supervisory body must play a prominent role in risk management, compliance and the institution's internal audit as well as in appointments and compensation. The largest entities must also set up specialised committees as offshoots of the supervisory body to which they report: risk committees, compensation committees, nomination committees and audit committees.

For example, ultimate responsibility for the effectiveness of the risk management system now lies with the supervisory body, which sets the firm's risk appetite level and overall risk tolerance thresholds by approving the main risk management policies and strategies. As such, it has to agree the undertaking's written policies, its ORSA, and when appropriate, an application for the use of an internal model.

In order to ensure that the supervisory body can properly fulfil its mandate, its composition must meet certain criteria that are set down in the regulations.

Individual suitability

First, the character and background of each member of the supervisory board should meet legally imposed criteria relating to:

- fit and proper qualification;
- experience;
- knowledge;
- expertise;
- time commitment;
- absence of conflicts of interest; and
- honesty, integrity and independence of mind.

Collective suitability

In addition to considerations of eligibility on an individual basis, the supervisory body must also demonstrate that from a collective point of view it has the expertise and experience needed to fulfil its duties properly. This gives it the broad perspective and hindsight needed to oversee management and make informed decisions on issues that fall within its remit.

Independence and absence of conflicts of interest

The supervisory body should also include independent members to help ensure that the interests of all internal and external stakeholders are taken into consideration and that independent judgement is exercised in the event of an actual or potential conflict of interest. However, this general principle is not a regulatory requirement in the insurance sector.

Effective decision-making

A final point, which is not explicitly stated in the regulations, deserves mention: the number of members on the supervisory body. The laws governing a firm's corporate form in France (the French Commercial Code, Mutual Insurance Code, Social Security Code and Monetary and Financial Code) may set a minimum and/or maximum number of members for the supervisory body for each legal form (18 for a French SA, for example). Aside from these constraints, undertakings are free to decide how many people sit on the supervisory body. However, the size of the supervisory body is the product of numerous parameters that can sometimes appear contradictory: it should have all the required expertise and sufficient diversity in terms of gender, age and background but it should not have too many members in order to ensure that collegial decision-making is as efficient as possible.

Compliance with the individual and collective quality criteria for the supervisory board is first and foremost the responsibility of the institution. It is therefore tasked with formally documenting its approach and putting it into practice.

It then falls to the supervisor to ensure that these criteria are properly observed. Even though, in contrast to the banking sector, insurance sector regulations do not provide for an *ex-post* confirmation procedure the ACPR may, as part of its permanent control duties, oppose the renewal of a supervisory body member's term of office.

These new governance requirements are thus intended to secure a supervisory body capable of monitoring the decisions taken by the governing body in order to guarantee the "sound and prudent management of the business". To this end, additional rules have been put in place to ensure a clear segregation of duties between the supervisory body and the governing body, whose functions have been defined in the regulations.

2 A more precise definition of executive functions

Solvency II stipulates that at least two people must be responsible for the effective management of insurance sector institutions.

Much like the managing director of a public limited company, who is invested with "the most extensive powers to act on behalf of the company in all circumstances" (Article L. 225-56 of the French Commercial Code), the persons charged with effectively managing a regulated institution must have wide-ranging powers.

Most of the legal forms adopted by the regulated entities allow the designation of at least two effective managers. For example, French SAs with a board of directors may appoint deputy managing directors to work alongside the managing director.

For those that have a supervisory board, every member of the board, as members of the collegial body in charge of executive management, is a person that effectively runs the firm. Legislation or guidelines (see the ACPR Notice of 2 November 2016 on the appointment of effective managers and key function holders under the Solvency II regime) recall or define, for each corporate form used, the functions that correspond to effective management of regulated entities.

The regulations also allow for the designation of a senior executive (generally a deputy managing director) as an effective manager. To this end, the deputy managing director must nonetheless be granted the necessary powers by the competent body: she or he must have a sufficiently comprehensive vision of the business and its risks and must be able to take the place of the other effective manager if the need arises.

Another key regulatory principle concerns the segregation of duties between the chair of the supervisory body and the managing director. If the head of the body responsible for supervising the activities of people exercising the highest executive functions is in fact one of those people, it is clear that this would create a conflict of interest that is all the more difficult to resolve given that the powers exercised are considerable.

There are no regulations in the insurance sector that formally prohibit dual hatting and combining the functions of chair of the supervisory body and managing director. However, good practices, particularly those set down in the Afep-Medef Code (*Association française des entreprises privées-Mouvement des entreprises de France*, the French association of private sector companies and the Movement of French enterprises) for listed companies and in the regulatory provisions that already apply in the banking sector, should in themselves encourage the largest insurance undertakings to apply them. The ACPR Notice of 2 November 2016 on the appointment of effective managers and key function holders also raises a point of attention in this respect:

"When the chair of the board of directors is appointed effective manager of an undertaking governed by the French Insurance Code, particular attention should be paid to the relationship between her or his role of effective manager and the role of the board of directors as it performs its supervisory function. In particular, the executive duties that the chair as the person effectively running the firm will be required to have must be accompanied by mechanisms that guarantee the board of directors' effectiveness as it is tasked with supervising the performance of the effective manager. However, in the case of a large group, especially if it is listed, the importance of the control and supervisory role assigned to the chair of the board of directors seems difficult to reconcile with the executive functions of an effective manager at the head of the group, insofar as she or he is not explicitly appointed managing director."

Insurance regulations grant the supervisor the possibility of opposing the designation of effective managers or the renewal of their term of office, if it is found that they do not or no longer meet the criteria set down in the legal texts (these are basically the same as those mentioned above for directors: fit and proper; experience; knowledge; expertise; time commitment; absence of conflicts of interest).

With the exception of the fit and proper requirement, the level expected for each of these different criteria is adjusted on the basis of the principle of proportionality. For example, to be an effective manager, significant experience in a similar position or in positions that prepared a candidate for these types of responsibilities is required.

3 Strengthening the internal control and risk management functions

After the 2008 financial crisis, and based on the acknowledgement that certain risks can only be adequately mitigated through requirements that target an institution's intrinsic governance, the effectiveness of the governance system became a critical issue during the adoption of the regulatory frameworks applicable to the banking and insurance sectors .

In addition to the supervisory body's aforementioned responsibility for overseeing and monitoring risk and for risk management, Solvency II also sets down critical risk and control management functions that must be performed by key personnel, who are thus charged with the responsibility of fulfilling precise demands.

Insurance undertakings must thus appoint four key function holders responsible for compliance,[1] risk management,[2] the actuarial function[3] and internal audit.[4]

1 The main task of the compliance function is to ensure that the undertaking or group complies with the regulations pertaining to insurance activities. As such, its head prepares a compliance policy and a compliance plan. The compliance function must also advise the governing and supervisory bodies on the risk of non-compliance arising from potential changes in the legal environment by identifying any implications for the undertaking.

2 The risk management function, through its risk management system, aims to permanently identify, measure, control, manage and report on the risks that face the undertaking or group. The risk management system covers all significant risks to the undertaking or group, given that underwriting, provisioning, asset-liability management, investment risk, operational risk, reinsurance and other risk mitigation techniques are covered. In the event that an internal model is used, the risk management function is responsible for the majority of its design, monitoring and maintenance. Lastly, the risk management function assists and reports to the board on risk management issues.

3 The actuarial function must enable analyses of the consistency, strengths and weaknesses (or uncertainties) of the technical management of the undertaking or group by covering all its aspects (pricing, underwriting, provisioning, reinsurance). These analyses form the basis of one or several actuarial reports that are presented to the board at least every year.

4 The mission of the internal audit function is to assess the appropriateness and effectiveness of the internal control system as a whole. It communicates its audit plan to the board and submits a written report to the board at least once a year with its findings, recommendations and the progress made on the action plans drawn up to address them.

Like the members of the governing body, the key function holders must also meet the expertise and fit and proper criteria that provide reasonable assurance that they will be able to adequately fulfil their mandate. Compliance with the individual and collective quality criteria for the key function holders is first and foremost the responsibility of the institution but it falls to the supervisor to ensure that these criteria are properly observed.

In the field of insurance, the French regulatory framework, in accordance with the provisions of Article L. 356 18 of the French Insurance Code, provides for an assessment by the ACPR of the suitability of holders of key positions at each appointment or renewal of office.

Furthermore, risk management has to take account of the use of outsourcing, including for essential services, which has expanded significantly over recent years as financial services have become increasingly digitalised. In certain cases, outsourcing has even become intrinsic to institutions' business models given the many potential advantages it offers, such as cost reduction, flexibility and access to or use of new technologies (Fintech).

However, over-reliance on outsourcing can generate additional risks for institutions in the event that the service provider experiences difficulties. Solvency II thus states that insurance undertakings shall remain fully responsible for compliance with their legal and regulatory obligations when using outsourced services, including intra-group subcontracting. Notably, outsourcing of "critical or important" activities must not lead to an impairment of the system of governance, an increase in operational risk, an impairment of the ability of supervisory authorities to monitor or an impairment of business continuity.

Undertakings are also required to notify the supervisory authorities of their intention to outsource critical or important activities. The ACPR issued an Instruction specifying the information required and the time period accorded for this prior notification.

Thus, as mentioned above, the governance rules applicable to the institutions supervised by the ACPR have been radically transformed since 2015. After five years implementing these new rules, the ACPR felt it would be useful to provide an overview of the changes it had observed and to share sound practices with the institutions it supervises to help them improve their regulatory compliance.

Governance findings and expected improvements

This chapter presents a summary of the ACPR's main findings from its inspections of supervised institutions with regard to the three main developments concerning the role and composition of the governing body in its supervisory function, a more precise definition of executive functions and the strengthening of internal control and risk management functions within supervised institutions.

1 The role and composition of the supervisory body

Findings

The ACPR found that for most of the undertakings under review, a formally documented process exists to ensure the expertise and fit and proper character of board members during their appointment, with some basing this on the overall fit and proper policy required by Solvency II. However, there is no regular re evaluation process to follow up this initial verification.

The ACPR also found that mutual institutions do not always have procedures for the different stages in the election of directors, and that when they do exist, the process seems insufficiently documented.

Following a review of the expertise and fitness of members of the boards, and where appropriate individual interviews to gain a clearer picture, the ACPR concluded that the level of collective expertise of board members within certain undertakings had to be improved. In some of the most critical cases, the ACPR determined that the level of the board's collective expertise was not even enough to provide effective oversight of the undertaking. Consequently, members appear to need training, particularly those that have limited experience in the insurance sector or who, in the mutual insurance sector, are unfamiliar with the specific requirements of mutual institutions.

Furthermore, not all the institutions have established procedures to deal with board member conflicts of interest.

The board needs to be given relevant information by the governing body to be able to exercise its role of control and supervision over the undertaking. The ACPR noted that on the whole this is the case, even if occasionally the ACPR considered that this information was sometimes too detailed and/or not made available sufficiently in advance to allow board members to familiarise themselves with the issues before discussing them during their meeting.

The ACPR also found that the proposals submitted for board deliberation did not always come with a reminder of any applicable regulatory obligations that may exist or with an analysis of the proposal in light of the development, risk appetite and solvency objectives previously set by the entity.

Lastly, within a group context, the ACPR reaffirms that the board has to deliberate on the strategy, development and prudential position of solo entities. For complex groups, this confirms the need for collective board expertise on prudential technical aspects.

With regard to risk management, the ACPR noted that most boards of directors have set up specialised committees, such as risk, audit and compliance committees, made up of expert administrators who study specific issues in great depth in order to report a summary of their findings during the board's meetings.

As such, the ACPR also found that the allocation of roles between committees was in most cases satisfactory and that the level of detail of the information reported to the board of directors by its specialised committees generally appeared appropriate. Nevertheless, certain failings were sometimes identified in terms of the composition and/or role of these committees (insufficient number of members on the audit committee, lack of exhaustive minutes, insufficient coverage of risk management issues).

In addition, while most boards of the publicly listed companies under review have independent members, their numbers can, however, be limited.

Although the boards of some undertakings are involved in reviewing and extensively discussing the ORSA, for a significant number of institutions, they do not always have an active role in the process. However, this is a regulatory requirement, reiterated in the ACPR Notice of 2 November 2016.

For many insurance undertakings, the compensation policies approved by the board of directors were insufficiently detailed and/or inappropriate for the Solvency II requirements. In particular, the variable compensation component of certain undertakings appeared excessive.

Thus, although supervisory bodies can point to examples of sound practices in their operations, they still have areas for improvement if they are to fully exercise the supervisory role conferred on them by the regulations.

Expected improvements

Supervisory bodies could further improve their operating performance, particularly with regard to the following three aspects:

- the board should formalise its assigned roles, its operating rules, in particular on dealing with conflicts of interest, and the powers it delegates to operational managers;
- undertakings should regularly assess the collective expertise of their boards and set up relevant training programmes;
- individually, each board member should be regularly assessed on a fit and proper basis in accordance with the conditions set out in ACPR Position 2019-P-01.[5]

With regard to the decision-making process, documentation should be sent to board members sufficiently in advance of their meetings to allow them to familiarise themselves with the issues under discussion.

The clarity of the information transmitted to the board at the time decisions are made also needs to be improved, particularly on the most technical questions. Furthermore, each proposal submitted for a board decision should always come with a reminder of any applicable regulatory obligations that may exist and with an analysis of the proposal in light of the development, risk appetite and solvency objectives previously set by the entity.

Within a group context, the board must deliberate on the strategy, development and prudential position of solo entities.

When specialised committees are set up to study more technical issues, the board must ensure that their composition is acceptable and that they operate properly.

The board must also take a greater role in the ORSA review, in compliance with the regulations reiterated in the ACPR Notice of 2 November 2016 and in accordance with the expected improvements set out below.

The board must also ensure that the approved compensation policies are sufficiently detailed and/or appropriate for the Solvency II requirements.

5 See *https://acpr.banque-france.fr/sites/default/files/media/2019/12/24/201912_position_2019-p-01.pdf*

6 Article R. 322-168 of the French Insurance Code states that the managing director, deputy managing director(s) and the members of the board effectively run the firm. In addition to these provisions, there is the possibility of appointing one or more natural persons, in particular the chair of the board of directors, as the effective manager under certain conditions (having a sufficiently broad area of expertise and powers over the firm's business activities and risks, being able to commit a sufficient amount of time, etc.).

2 A more precise definition of executive functions

Findings

In the absence of a binding legal regime,[6] the roles of effective manager and chair of the supervisory body are performed by the same person in a large number of undertakings. Thus, dual hatting was observed in 116 of the 279 undertakings governed by the French Insurance Code at the end of 2018 (including a significant proportion of medium and large enterprises, with a turnover in excess of EUR 50 million) with the same person serving as both effective manager and chair of the supervisory body.

This count includes dual hatting as effective manager and chair of the board of directors (53%) and as effective manager and chief executive officer (CEO, 47%).

Given the head of group's dominant influence, including in policyholder/customer-owned groups, its governance must be ensured by separating supervisory and executive functions, i.e. with a chair of the board of directors who does not have an effective management position, such as managing director.

In this respect, although the ACPR College has already requested, and secured, the segregation of duties within several heads of groups and large undertakings, further progress is still required as:

- there was no segregation within eight heads of groups that could not invoke the principle of proportionality due to their size;
- within groups in which, at their head, governance was not segregated from the executive functions, around fifty subsidiary or affiliated entities presented situations of dual hatting, combining the functions of effective manager and chair of the supervisory body, including five entities with turnover of more than EUR 1 billion;
- within groups in which the governance of its head complied with the segregation of executive and supervisory functions, there was dual hatting in around ten entities with turnover of more than EUR 1 billion.

Lastly, it should be emphasised that under the French Mutual Insurance Code, the chair of the board of directors is the effective manager by right. This is a specific provision that seems well suited to the specific characteristics and background of historic French mutual insurers known as *Mutuelles 1945*. However, the ACPR found that this particularity loses its relevance in groups of a certain size and especially when these groups are made up of entities governed by different legal codes.

Lastly, the ACPR observed that within large groups, effective managers accumulated a significant number of executive positions (in some cases more than ten), which may throw into question the time available to managers to take the operational lead of the entities in question, particularly if they are sizeable. Combining roles in this way may contribute to group cohesion but it is necessary to demonstrate that the person double hatting has enough time and availability in practical terms.

Expected improvements

In the absence of a change to the regulations, the ACPR judges it necessary to strengthen the principle of a clear and precise segregation between executive functions and supervisory functions in order to guarantee the "sound and prudent management of the business" by referring back to the following fundamentals.

- The segregation of executive and supervisory functions is a principle of good governance and should be promoted, while non-segregation (combining the chair of the board with an effective manager or CEO function) should be an exception and should be justified by the undertaking.
- In certain cases such as heads of groups or listed companies, non-segregation appears particularly unacceptable given its major consequences in terms of risk.
- In certain cases, non-segregation may be envisaged on the grounds of proportionality (undertakings meeting the criteria of proportionality defined in the ACPR Notice of November 2016, or wholly-owned subsidiaries, excluding those that are very large, even when

the head of group is subject to executive and supervisory function segregation), but should be combined with measures that guarantee the independence of supervisory bodies (such as independent directors or senior directors).

- Lastly, the expertise of the chair of the board may, particularly in the case of large mutual institutions, be a point of attention given the essential role she or he plays in the undertaking's control and supervisory functions.

3 The internal control and risk management functions

Findings

Key function holders

As of 1 January 2016, insurance and reinsurance undertakings governed by the Solvency II regime and groups within the meaning of Article L. 356-1 of the French Insurance Code (hereinafter "groups") shall have a single individual responsible for each of four key functions: internal audit; risk management; the actuarial function; and compliance.

With regard to these four key function holders, the ACPR Notice of 2 November 2016 on the appointment of effective managers and key function holders under the Solvency II regime notably established:

- a baseline situation excluding any double hatting and providing for direct reporting by the key function holder to the effective managers;
- precise criteria – with a particular focus on the head of the key function of internal audit – for the application of the principle of proportionality based on which double hatting may be considered under specific conditions;
- lastly, the possibility for undertakings not subject to the principle of proportionality to deviate from the baseline situation if the institution and the procedures put in place (in particular the absence of conflict of interest, the possibility for key function holders to report directly to the board of directors, availability, etc.) mean that the objectives described in the Notice, particularly in Chapter I, can be fulfilled.

The ACPR General Secretariat (SG ACPR) regularly monitors the situation on the French market.

Thus, at the end of 2017, double hatting was seen in 159 of the 519 undertakings subject to Solvency II. While in most of these cases this was considered acceptable with regard to the defined proportionality criteria, the ACPR found that more than 50 of those undertakings failed to meet these criteria (undertakings not eligible for the principle of proportionality or for double hatting that combines responsibility for the internal audit function).

Each case systematically resulted in discussions with the undertaking and its commitment to ending the arrangement. A mid-2019 review of the undertakings showed that the picture was improving and that there had been a 50% reduction in problematic cases.

The ACPR also found that, even where double hatting was considered acceptable under the principle of proportionality, in the majority of cases the requirement for specific arrangements to avoid conflicts of interest was still poorly understood and continued to be questioned with the ACPR's departments.

Furthermore, the ACPR found that key functions holders' access to the board in some undertakings was not always guaranteed or effective.

The Own Risk and Solvency Assessment (ORSA)

The regulations also defined the risk appetite framework and the Own Risk and Solvency Assessment (ORSA) process in the risk management system, so that undertakings monitor their solvency on the basis of the specific features of their risk profile and the strategic orientations they intend to take.

However, in undertakings of all sizes, inadequacies were identified with regard to these two requirements, which prevented them playing their proper role.

Risk appetite is monitored to varying degrees by the vast majority of undertakings and is systematically expressed in terms of capital adequacy and sometimes in terms of earnings or credit ratings. However, it emerged that a minority of undertakings did not sufficiently take it into consideration for management purposes: a failure to comply with the risk appetite levels expressed by the supervisory body did not result in remedial action. Furthermore, in the vast majority of cases the consistency between risk appetite levels (particularly technical risks) and operational limits was not systematically checked. As a result, compliance with these limits did not guarantee *a priori* compliance with risk appetite levels, leading to the great majority of supervisory bodies adopting a retrospective rather than proactive approach. This practice means that the impact on risk appetite levels is not taken into account when making strategic decisions.

The ACPR also found that breaches of operational limits or risk appetite levels were not systematically reported to the supervisory body.

The ACPR feels that the ORSA process is still not sufficiently integrated in the strategy definition and decision making procedures of the sampled undertakings, as explained below.

- Based on the ORSA reports analysed for the undertakings under review, and whose preparation is coordinated by the risk management function, the information presented to the supervisory body did not generally appear to be sufficient for the institution to be able to discharge its duties in an informed manner. For example, the overall solvency requirement was not always assessed during an ad hoc ORSA relating to an acquisition that nonetheless significantly changed the acquirer's risk profile. With respect to assessments of the ability to meet regulatory capital requirements over the strategic plan horizon, some undertakings based them on projection scenarios that were not sufficiently conservative without providing the explanations needed. Others did not appear to have sufficiently studied unfavourable scenarios in relation to their risk profile, and others again did not use the latest version of their financial development plan. The ACPR also noted that there was generally little discussion with committee members (both specialised committees and the board) on the choice of stress scenarios and on the results available to operational staff. The situation thus arose in which insurance undertakings duplicated scenarios applied to banking entities without any criticism from board members as to their unsuitability to the insurance sector. Thus, while the ORSA reports may have improved since Solvency II entered into force, governance reviews of some heads of group identified, for example, that their ownership of the three ORSAs remained incomplete and that their monitoring of subsidiaries' work on the ORSA was insufficient.

- The majority of undertakings had still not sufficiently documented their ORSA policy, including undertakings for which the policy had not yet been finalised at the time of the governance reviews. In particular, the ACPR observed that some undertakings did not sufficiently highlight the active role that the supervisory body should play. In addition, certain undertakings had not clearly defined the procedures for the ad hoc ORSA (the conditions requiring its preparation, its content, etc.). Lastly, the allocation and coordination of roles and responsibilities between the head of group and its subsidiaries was sometimes insufficiently documented.

- For more than half of the undertakings, the risk mapping in place and on which the ORSA process is based did not appear to be reliable enough due to a lack of completeness, consistency and/or assessment of risk severity. In some cases, its connection with the internal control system was wanting. All the groups have implemented remedial actions.

The supervisory body and particularly the audit committee of the undertakings also monitor the implementation of written policies and procedures, primarily through periodic reviews of the internal audit function, whose performance is generally satisfactory. However, the ACPR noted that audit assignments in entities within a group, although scheduled in the audit plan, had been cancelled due to a lack of time and/or resources dedicated to the entities, without the board of the undertaking concerned being informed.

The permanent control systems of most of the undertakings whose systems were assessed for effectiveness were found to be flawed and deficient (a lack of risk mapping, for example), even highly inadequate in some cases, and did not provide assurance that the institutions' written policies had been properly implemented. For some heads of group, these shortcomings could be seen both at the level of the internal control of their minimum requirements vis-à-vis entities and in their own procedures (although they have undertaken major projects to strengthen their internal control). Furthermore, for several of the undertakings under review, the information on the permanent control system reported to the supervisory body was inadequate and did not allow it to properly fulfil its oversight role.

Lastly, as several undertakings indicated, the compliance function's contribution to the internal control system was generally insufficient, even though the regulations make it a first and second line of defence. Some undertakings had still not formalised their compliance plans or had simply collated the compliance plans of the different entities at group level, resulting in a document that did not necessarily reflect the risks specific to the group. In addition, the findings of compliance reviews were not always formally documented or presented to the board of directors.

Broadly speaking, the practices observed for the undertakings under review as a whole were not consistent with the regulatory requirements or internal control monitoring best practices.

Lastly, when the actuarial reports were analysed as part of the governance review, for almost all of the undertakings they did not fully comply with the regulatory requirements and/or were not considered to be of sufficient quality. In addition, where the actuarial function was operating at head of group level, the ACPR found that the time allocated by the group head of key functions to the entities was inadequate and that reporting from the entities to the group head of key functions was insufficient. This prevented the latter from fully discharging its supervisory role, particularly with regard to the reliability of provision calculations and compliance with underwriting and reinsurance rules.

As for small undertakings, the expertise of the heads of the actuarial function on prudential matters was still insufficient to assess the work that was often outsourced to consultancy firms.

Outsourcing

The defaults among foreign players in the construction industry, which were notably linked to the business model of the wholesale insurance broker in addition to the complexity of construction insurance, call for vigilance from the ACPR with regard to the provisions of the Insurance Distribution Directive but also with regard to the Solvency II provisions on outsourced activities.

The ACPR found that insurance undertakings did not properly manage their outsourced activities. For almost all the undertakings, monitoring of outsourced functions through the internal control system and by the supervisory body appeared insufficient and in some cases highly inadequate. The ACPR particularly noted that within some undertakings there was no oversight of delegated managers and insurance distributors.

Reporting to the ACPR of critical or significant outsourced activities was more or less done according to the type and size of the undertaking and their definition of a critical or significant activity. Written policies on this issue were often incomplete and did not break down outsourcing by critical, important or non-material functions. In general, the methodology governing the analysis prior to the decision to outsource, the identification of a critical activity, and the evaluation and ongoing supervision of outsourcers were not always sufficiently detailed (definition of indicators, verification that business continuity plans are in place, possibility of performing on-site audits, etc.). The guidelines issued by groups to their entities did not always ensure that practices were consistent within the group, nor did they prevent shortcomings. The ACPR also noted that the declaration form made available to undertakings was not always used and that the content of these declarations was therefore inconsistent. Moreover, the outsourcing requirements for the narrative reporting in the Regular Supervisory Report (RSR) and the Solvency and Financial Condition Report (SFCR) were not always complied with (list of critical outsourced activities, description of outsourcing policies, etc.).

Expected improvements

The positioning and role of the key function holders remain a point of attention, even if cases of unacceptable double hatting are falling.

The quality of arrangements for managing conflicts of interest must also be a point of attention within undertakings that continue to practice double hatting in keeping with the principle of proportionality.

Furthermore, the availability and scale of the resources made available to the key function holders to carry out their supervisory duties remain an issue, particularly within groups, which tend to appoint an overall head of key functions for all group entities. As in the case of combined effective management functions, if this situation helps to ensure cohesion within the group, it must be shown that the key function holders can devote enough time and availability to each entity. This is something that undertakings must be constantly alert to, and not just at the time the head is appointed.

The undertakings must increasingly adopt the ORSA mechanism as (i) a tool for strategic decision-making by the supervisory body and (ii) a means to manage their business activities by rolling it out across operations.

Furthermore, the formulation of stress test assumptions and scenarios must also be improved in order to take better account of undertakings' risk profiles.

Lastly, outsourcing remains a vulnerability to which undertakings must pay far closer attention, from its inception to its management and control. Undertakings must undertake to categorise their outsourced activities and report those that are critical and significant by following the instructions and templates available on the ACPR website. As such, the ACPR expects to see better documentation and better implementation of outsourcer monitoring over the life of the outsourcing arrangement.

Conclusion

All the provisions referred to in this report relate to issues of governance implementation (particularly segregation of duties, the composition of supervisory bodies, and executive functions) and to fundamental measurable criteria for effective governance (expertise, experience, time commitment, etc.).

However, governance clearly concerns more than these elements alone. The effectiveness of the governing body in performing its executive and oversight duties depends on the ethics, values, culture and behaviour of its members, both individually and collectively. These themes have therefore become an increasing point of attention, particularly for supervisors, even though their definition and assessment can be complicated.

In the wake of the Group of Thirty (G30) report, *Toward effective governance of financial institutions*, and guidance from the Financial Stability Board in April 2014,[7] the Basel Committee's guidelines on *Corporate governance principles for banks* in July 2015,[8] which can also impact developments in insurance, emphasised the importance of corporate culture and values.

The guidelines propose a definition that establishes a relationship between corporate culture and the risks taken by banks.

"Risk culture:
A bank's norms, attitudes and behaviours related to risk awareness, risk taking and risk management and controls that shape decisions on risks. Risk culture influences the decisions of management and employees during the day-to-day activities and has an impact on the risks they assume."

One of the tasks of the board of directors and senior management must be to harmonise corporate culture, business activities and employees' behaviour in order to ensure sound, prudent and honest management that complies with the laws and regulations in force.

Good corporate governance practices are organised into 13 principles in the guidelines, 9 of which specifically mention the concepts of culture and values.

Corporate culture reaches far beyond the written rules that define corporate governance. However, good governance is a prerequisite for good corporate culture. The supervisory body is the last line of defence against poor decision-making. However, it is important to remember that there are three other equally important lines of defence. The first is the business lines themselves. The second is the risk management function and the compliance function, i.e. the two key function holders that assess the business decisions taken and propose measures to mitigate their risks. The third is the internal audit function, which assesses the effectiveness of internal controls, risk management and governance. It is thus essential that the overall effectiveness of this governance is comprehensively assessed and regularly reviewed by the supervisory body.

Compensation is another aspect that has a direct influence on sound incentives and corporate culture, as financial incentives are extremely influential on decision-making at the individual level.

7 *Guidance on supervisory interaction with financial institutions on risk culture*, April 2014.

8 *Corporate governance principles for banks*, Basel Committee on Banking Supervision, July 2015.

CONCLUSION

In Europe, the rules introduced after the 2008 financial crisis seek to support this objective by giving more weight to long-term management.

However, these rules still offer significant leeway to institutions that do not always meet supervisors' expectations.

Work is therefore needed in this area, either as part of the revision of the European regulatory framework or as part of the European supervisory authorities' efforts to harmonise practices.

Appendix
Methodology and objectives of the governance review

The review consists of an analysis of an extensive body of documentation collected from institutions supervised by the *Autorité de contrôle prudentiel et de résolution* (ACPR, Prudential Supervision and Resolution Authority) and supplemented through interviews held with their executives and control function heads and with members of their supervisory bodies (chair of the board of directors and/or president of the risk committee).

Furthermore, as part of their governance reviews, ACPR representatives attended meetings of the supervisory bodies as observers.

The thematic governance review carried out by the ACPR General Secretariat (SG ACPR) was performed on a broad sample of all types of undertakings (insurance firms, provident institutions, mutual insurers, holding companies, etc.), most of which were large in size.

For the more modest undertakings in the sample, the principle of proportionality provided for under Solvency II was taken into consideration as part of the inspections performed.

SG ACPR representatives attended board meetings and met individually with the board members of certain undertakings.

The conclusions of each of the reviews were freely discussed with the undertakings and their responses were taken into consideration before the final inspection report was prepared. On the basis of this report, the board of directors is required to validate an action plan to remedy any regulatory shortcomings that may have been identified.

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