

OECD GUIDELINES ON INSURER GOVERNANCE

2011



The *OECD Guidelines on Insurer Governance* were established as an OECD Recommendation in 2005. This brochure reproduces the revised *Guidelines on Insurer Governance* agreed by the Council on 19 May 2011. The *Guidelines* complement the principles on pension fund governance in the *OECD Recommendation of the Council on Core Principles of Occupational Pension Regulation* and the *OECD Principles of Corporate Governance*.

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RECOMMENDATION OF THE COUNCIL ON GUIDELINES ON INSURER GOVERNANCE

As amended on 19 May 2011

THE COUNCIL,

Having regard to Article 5b) of the Convention on the Organisation for Economic Cooperation and Development of 14 December 1960;

Considering that OECD Ministers agreed in 2002 that implementation of best practices in corporate and financial governance entails an appropriate mix of incentives, balanced between regulation and self-regulation, and that such governance should be improved to enhance transparency and accountability and thereby strengthen investor confidence and the stability and resilience of financial markets;

Considering that the soundness and integrity of financial institutions and their conduct toward consumers depends not only on regulation and supervision, but also on the quality of governance practices within financial institutions;

Considering that the governance of financial institutions, including insurance providers, should be of a high standard and serves as a key element of the regulatory and supervisory framework;

Considering that the specificity of the business activities, risks and responsibilities of insurance providers call for specific guidance on insurer governance in addition to the more general standards provided by the OECD Principles of Corporate Governance;

Considering that the Guidelines on Insurer Governance (hereinafter called “the Guidelines”) complement the principles on pension fund governance in the Recommendation of the Council on Core Principles of Occupational Pension Regulation and the OECD Principles of Corporate Governance, and that the Corporate Governance Committee is of the view that the Guidelines are fully compatible and consistent with the Principles of Corporate Governance;

Considering that efforts have been made by the insurance sector and regulatory and supervisory authorities in recent years to strengthen the governance practices of insurers;

Considering that these Guidelines are meant to provide non-binding guidance to the insurance sector as a whole, including stock companies, mutual insurers or any other type of insurance providers, operating as direct insurers or reinsurers domestically or internationally – (hereafter “insurers”);

Considering that the Insurance and Private Pensions Committee has elaborated these Guidelines on the basis of national experiences and the experiences of relevant international institutions and organisations, in particular the International Association of Insurance Supervisors;

Recognising the review of the 2005 Guidelines on Insurer Governance carried out by the Insurance and Private Pensions Committee and the joint work conducted with the International Association of Insurance Supervisors as part of this review;

Recognising that developments in the insurance sector or the Principles of Corporate Governance may call for further updating and revision of these Guidelines;

On the proposal of the Insurance and Private Pensions Committee:

RECOMMENDS that Members invite public authorities and insurers to ensure a sound governance framework for insurers, having regard to the contents of the Annex * to this Recommendation of which it forms an integral part.

INVITES Members to disseminate these Guidelines among public and private insurers.

INVITES non-Members to adhere to this Recommendation.

INSTRUCTS the Insurance and Private Pensions Committee to exchange information on experiences with respect to the amended Recommendation, review that information and report to the Council within three years and, as appropriate, thereafter.

* The text of the *OECD Guidelines on Insurer Governance* is reproduced in Part I of this document.

PART I

OECD GUIDELINES ON INSURER GOVERNANCE

INTRODUCTION

The following guidelines are applicable to any insurer licensed to underwrite life, non-life and reinsurance policies and take into account the specificities of the sector. They are designed in light of the overriding objective of an insurance undertaking, which is to provide benefits to the insured in accordance with the contracts concluded with them, and satisfy its shareholders (member-policyholders in the case of mutual insurers). Given the specificity of the reinsurance business, some guidelines relating to stakeholder protection may not be fully applicable.

The guidelines are organised around four main sections: (i) governance structure; (ii) internal governance mechanisms; (iii) groups and conglomerates; and (iv) stakeholder protection. The guidelines are structured in such a way as to promote clear presentation and comparability with other possible national or international rules or principles. Some specifications to the guidelines have been provided, in grey boxes, to guide implementation. The guidelines are also accompanied by detailed annotations that elaborate more fully on the guidelines and their rationale.

These guidelines are non-binding. They are meant to provide guidance and serve as a reference point for policymakers, insurers and other relevant stakeholders in OECD and non-OECD countries. As such, policymakers and market players may apply them if they so wish in accordance with their regulatory and supervisory framework and the specificities of their jurisdiction (e.g., through corporate law, insurance sector legislation or rules and/or through codes of conduct established by the industry). While the guidelines are largely principles-based and thus should be flexible in their application, due recognition should nonetheless be given to the principle of proportionality; the guidelines may need to be tailored or applied in such a manner as to reflect the nature, scale and complexity of the business of specific insurers and the risks to which they are exposed.

These guidelines are consistent and compatible with the *OECD Principles of Corporate Governance*, which they complement.

I. GOVERNANCE STRUCTURE

The governance structure should have an appropriate allocation of oversight and administrative responsibilities, stipulate and delineate clearly the duties, responsibilities and qualifications of persons having responsibilities, and protect the rights of shareholders (or member-policyholders) and the interests of policyholders.

A. Board of directors

1. Key duties

- Members of the board of directors (“board members”) should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the insurer.
- Board members should take into account the interests of policyholders in their decision-making and, as appropriate, the interests of other stakeholders.¹

2. Responsibilities

- The board should set the direction for and oversee the affairs of the insurer and ensure that it meets its strategic objectives and is managed efficiently and prudently. The board should establish appropriate policies and an effective governance system to achieve these aims.
- Board members should set the “tone at the top” by establishing and promoting a proper risk culture and an ethical and sound control environment, and by leading by example.
- The board should oversee the implementation of board policies and decisions by management. The board should meet regularly with management to review progress against objectives and assess the implementation of board policies and decisions.
- The board should ensure that it has access to accurate, relevant and timely information and can access relevant persons within the organisation. The board should ensure that an integrated, firm-wide information and reporting system is established.
- Board members should understand their responsibilities and dedicate sufficient time and energy to fulfilling them.

a. Values and objectives

- The board should establish the fundamental values and objectives of the insurer, consistent with the expected role and activities of insurers in the financial system and, in some countries, the social security system.
- These values and objectives should be communicated widely throughout the insurer.

b. Ethics, business conduct and conflicts of interest

- Board members should adhere to high standards of ethics and business conduct and apply such standards to all persons employed by the insurer.
- Board members should avoid any activities or influences that present an actual or apparent conflict of interest and would impede them from fulfilling their key duties.

¹ E.g., employees, creditors, consumers and supervisors.

Policies and procedures should be established to:

- promote ethical and sound business conduct and identify, monitor and resolve ethical or business conduct problems*
- identify, monitor and resolve actual or potential conflicts of interest facing board members, management and shareholders*
- govern related party transactions (including, if applicable, intra-group transactions); such transactions should be conducted at arms' length*

c. Governance system

- The board should clearly define the insurer's governance system and oversee its internal organisational structure to ensure that there are clear lines of responsibility and accountability as well as proper oversight and transparency.
- The board should define the expected roles and responsibilities of the board and its members as well as the relationship of the board with key executives and management.
- The board should review the governance system and practices on a regular basis and as circumstances warrant in order to ensure their effectiveness.

d. Strategy, business lines and key operational decisions

- The board should develop and establish the overall strategy of the insurer, its business objectives and major plans of action, and monitor performance against them.
- The board should oversee insurance business line activities and product development and related underwriting, pricing, reinsurance strategies and provisioning needs.
- The board should be implicated in any major organisational and operational decisions, including any outsourcing of key operations or functions.

e. Risk management, internal controls and control functions

- The board should establish a comprehensive and well-defined risk management framework or strategy that defines the insurer's approach to risk, sets out the methods employed by the insurer to mitigate risk, clearly identifies those responsible for implementation and reflects expected prudent behaviour on the part of the insurer.
- The board should establish an internal control framework that sets out the policies, processes and procedures (including internal reporting) necessary to ensure the proper observance and execution of board strategies and policies.
- The board should oversee the establishment of a comprehensive risk management and internal control system and ensure its overall effectiveness, soundness and integrity.
- The board should ensure the establishment of appropriate internal oversight functions ("control functions") charged with implementing or ensuring adherence to board policies on governance, risk management, internal controls, financial reporting and compliance, and recommending improvements where necessary.

- The board should oversee these control functions, including:
 - their mandate, scope of activities, authority, independence and resources
 - their organisational structure, reporting lines and the relationship among the control functions
 - the process for selecting the persons in charge (“heads”) of the control functions
 - their quality and effectiveness

Policies on underwriting and provisioning, reinsurance, investments, concentrations, asset-liability management, derivatives, liquidity management, business and operational strategies and processes (including business continuity planning and outsourcing), compliance and reputation (including group contagion if relevant) should be established as part of the risk management framework.

Policies should be established to define the mandate, scope of activities, authority and independence of the control functions and, as determined by the board, the role of the board with respect to them.

f. Financial condition, risk profile and capital position

- The board should regularly assess the financial condition, risk profile and solvency position of the insurer and assess capital, borrowing and liquidity needs.
- The board should review and approve borrowing, share issuance and repurchases and dividends, subject to any necessary shareholder (or member-policyholder) approval.
- The board should review and approve the budgets and financial statements and related discussion and disclosures, and ensure that the financial statements are prepared in accordance with the applicable financial reporting framework and high-quality accounting principles and represent fairly the financial condition of the insurer.

g. Selection of key executives, performance monitoring and succession planning

- The board should select key executives on a proper and fit basis and establish a well-defined succession plan, taking into consideration the insurer’s needs and objectives.
- The board should establish performance objectives for key executives, monitor their performance and replace them as necessary.

h. Compensation

- The board should establish compensation arrangements for board members, management and employees that promote prudent behaviour consistent with the insurer’s long-term interests and fair conduct toward consumers and policyholders.
- The board should take steps to ensure that compensation is established through an explicit governance process where the roles and responsibilities of those involved are clearly defined and separated. Non-executive board members should play a significant role in this process.

A compensation policy should be established as the basis for compensation arrangements. Compensation policies and related implementation measures should be submitted to the annual meeting of shareholders (or member-policyholders) for information, with an opportunity provided for discussion.

i. Disclosure

- The board should oversee the process of disclosure and communications.

3. Composition and suitability

a. Fitness and propriety

- Board members should have the necessary competency, skills, expertise and professional experience to direct and oversee the insurer in a professional manner.
- The board should, as a whole, have the requisite insurance, financial, accounting, actuarial, management and leadership expertise and skills to provide direction for and oversee the insurer.
- Board members should be of sound character and good repute and have the necessary judgement, leadership, independence and prudence to provide sound, strategic direction to the insurer and perform effective oversight.

b. Independence

- The board should, collectively and individually, demonstrate independence and exercise objective and impartial judgement in the affairs of the insurer.
- There should be a sufficient number of non-executive board members (at least a majority) to provide the basis for independent decision-making. These board members should be free of any influences that might limit their capacity to act in accordance with their key duties and provide objective oversight.
- The board should establish transparent criteria for independence and identify those board members who are considered to be independent on this basis.

In order to promote greater independence of decision-making in a group structure, a substantive proportion of non-executive board members should be independent of the group and its management.

Separation of the position of chair and chief executive officer may be regarded as good practice. Where the positions are combined, the board should hold sessions without executive members or other management present and consider appointing a lead independent director with a clear mandate and authority. In addition, for large, complex insurers, there should be an explanation of the measures that have been taken to avoid conflicts of interest and ensure the integrity of the chair function.

c. Performance

- The board should review, at least annually, its performance to assess board effectiveness and independence and identify opportunities for improvement.
- As part of this assessment exercise, the board should conduct an evaluation of individual and board performance, assess the structure and exercise of board leadership, review board composition, identify gaps in skills or knowledge and ensure that training programmes are established to respond to training needs.

d. Nomination and selection

- There should be a formal and transparent process for the nomination, selection and removal of board members, in compliance with any legal or by-law requirements. The term of office of board members should be specified in order to ensure regular board renewal.
- The process should seek to identify persons with the knowledge, competencies and expertise needed by the board, and place emphasis on the independence of prospective board members.

4. Reporting

- Board members should report on a periodic basis (at least annually) to shareholders (or member-policyholders), including through the general meeting or assemblies of shareholders (or member-policyholders), and to other stakeholders as relevant.

5. Accountability

- Board members are accountable to shareholders (and member-policyholders) for their performance and the general direction and overall management and performance of the insurer.

The board should consider establishing a board charter that sets out the role, structure, composition and responsibilities of the board.

B. Key executives

1. Key duties

- Key executives should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the insurer.
- Key executives should take into account the interests of policyholders in their decision-making and the interests of other stakeholders as may be determined by the board.

2. Responsibilities

- Key executives should:
 - Set, with the board, the proper “tone at the top” by supporting the development and implementation of a proper risk culture and control environment throughout the insurer and by promoting and adhering to high standards of ethics and business conduct
 - Recommend and implement board strategies, policies and decisions and efficiently manage the day-to-day operations of the insurer
 - Identify and monitor the key risks facing the insurer and undertake actions to manage, control, or mitigate them
 - Ensure that an effective risk management and internal control framework is implemented and ensure compliance with applicable laws, regulation and standards

- Develop and manage a comprehensive and operationally oriented risk management and internal control system, ensure its effectiveness, soundness and integrity, and ensure that corporate governance is an integral element of this system
- Establish sound internal governance practices and effective internal organisational structures
- Establish control functions, ensure their effectiveness and independence and communicate their importance throughout the insurer
- Establish appropriate compensation systems and incentive structures to promote prudent behaviour consistent with the long-term interests of the insurer and fair conduct toward consumers and policyholders
- Promote effective human resource management, including through recruitment policies and activities, training and succession planning
- Establish an integrated, firm-wide information and reporting system, and monitor the achievement of objectives, strategies, policies and plans approved by the board

3. Fitness and propriety

- Key executives should have the necessary competency, skills, expertise and professional experience to direct and manage the insurer.
- Key executives should be of sound character and good repute and have the necessary judgement, leadership, initiative, teamwork qualities and prudence to manage the operations of the insurer safely and achieve strategic and operational objectives.

4. Reporting

- Key executives should report to the board and any of its committees on a regular basis and, to this end, should provide accurate, relevant and timely information to the board in a clear and intelligible manner and ensure that this information is well understood.
- Key executives should promptly inform the board of any material matters that come to their attention and deserve or require board consideration, decision or approval.
- Key executives should seek to address the information needs or requests of board members and develop training programmes for them as appropriate.

5. Accountability

- Key executives are accountable for their performance and the direction, management and performance of the insurer.

C. Board structures

1. Committees

- The board should establish committees, where appropriate, to improve the effectiveness, efficiency, quality and independence of board decision-making, and enhance the oversight and governance of the insurer.

- Responsibility for board decision-making should ultimately rest with the board. The board should review the performance of its committees at least annually.

2. Mandate, authority and responsibilities of committees and their composition

- The board should clearly define the mandate, authority and responsibilities of any established committees, as well as their composition and working procedures.

The board should establish a charter for each of its committees outlining its mandate, authority and responsibilities.

3. Independence

- Committees of the board addressing matters where there is a potential for a conflict of interest should comprise a majority of non-executive board members in order to ensure the independence of decision-making.

The independence of decision-making and appropriate safeguard measures should be ensured in relation to reviews of related party transactions, financial and non-financial reporting, the nomination of board members and selection of key executives, the appointment or dismissal of the auditor or actuary, major outsourcing arrangements, and compensation.

Board committees addressing such matters should, where possible, be comprised fully of non-executive board members. In order to promote greater independence in a group structure, at least a majority of the board members of these committees should be independent of the group and its management.

4. Reporting

- Committees should, on a regular basis, report to the board on the conduct of their affairs and provide recommendations to the board on matters delegated to them for review and consideration.

5. Audit committee

- An audit committee should be established to review proposed financial reporting and related disclosures and oversee internal and external audit.
- The responsibilities should include:
 - Reviewing the insurer's financial statements and related discussion and disclosures prior to their submission to the board, reviewing and assessing the insurer's accounting policies and practices, ensuring appropriate internal controls over financial reporting and reviewing any financial or actuarial returns or reports provided to supervisor
 - Recommending the appointment of the external auditor, ensuring his/her fitness, propriety and independence, approving the audit plan and audit fees, reviewing and approving any non-audit services and fees, reviewing audit findings and assessing their implications for financial reporting and internal controls and taking necessary corrective actions, and reviewing the external auditor's performance
 - Reviewing and discussing internal audit plans and reports prepared by the internal audit function and taking necessary corrective actions

- The audit committee should have unfettered access to all key executives, the head of the internal audit function, the actuary and other relevant persons, as well as to all relevant data, reports, documents and information.

6. Other structures

- The board should consider the merits of establishing other possible structures to enhance the governance of the insurer.

D. External auditor

1. Role and responsibilities

- An external auditor should perform an audit of the accounts of the insurer at least annually to assure the board and shareholders (and member-policyholders) that the financial statements fairly represent the financial position and performance of the insurer in all material respects, in accordance with the applicable financial reporting framework and high-quality accounting principles.
- The external audit should be conducted in accordance with high-quality standards of auditing that are subject to independent public oversight.
- As part of the external audit, the external auditor should verify the insurer's internal controls over financial reporting.
- The external auditor should verify the value of the insurer's policy liabilities and the appropriateness of its technical provisions.
- The external auditor should perform all other duties as specified by external audit requirements in the country, which may include conducting a review of the insurer's risk management and internal control system.

2. Appointment

- The shareholders (or member-policyholders or their representatives), the board or the audit committee should appoint the external auditor.
- The dismissal or resignation of the external auditor should be reported to the supervisory authority and, as appropriate or required, be publicly disclosed.

3. Fitness and propriety

- The external auditor should have the necessary competency, skills, expertise (particularly accounting, audit and actuarial) and professional qualifications and experience to act in accordance with his/her duties and responsibilities as an external auditor of an insurer.
- The external auditor should be a member in good standing in a professional association that requires adherence to sound standards of auditing, quality control and ethics, and is subject to independent public oversight.

4. Independence

- The external auditor should exercise his/her duties independently, free from influences of the board, management and controlling shareholders.

5. Access

- The external auditor should have access to all relevant persons (including those performing the actuarial function) and information in order to carry out his/her duties.

6. Reporting

- The external auditor should report his/her findings to the board or its audit committee and, as may be required or as appropriate, to shareholders (or member-policyholders). The external auditor should discuss significant matters or disagreements with the audit committee. The external auditor should report material adverse findings on internal controls over financial reporting or material irregularities to the audit committee, as well as any findings raising questions about the insurer's viability.
- If the external auditor, in the course of his/her duties, becomes aware of any material irregularities (accounting or otherwise), actual or likely non-compliance with applicable laws and standards, or any matter uncovered in the performance of his/her duties that has or is likely to have a material adverse affect on the financial condition of the insurer, he/she should inform the supervisory authority promptly.

7. Accountability

- The external auditor should be accountable to the shareholders (or member-policyholders) and owe a duty to the insurer to exercise due professional care in the conduct of the audit.
- His/her term of office should have a specific duration. The performance of the external auditor should be subject to a board review prior to any reappointment.

II. INTERNAL GOVERNANCE MECHANISMS

Insurers should have appropriate control, incentive and communication mechanisms and internal organisational structures that encourage sound and prudent internal decision-making and promote the efficiency and transparency of operations.

A. Risk management and internal control system

- An insurer should have a strong, comprehensive and integrated risk management and internal control system that fully and effectively:
 - Implements the risk management framework or strategy
 - Implements the internal control framework
 - Considers risks arising from compensation arrangements and incentive structures
 - Ensures effective communication and reporting of risks across the organisation
- The risk management and internal control system should be well integrated into the insurer's overall system of governance.

B. Control functions

- Control functions should be established within an insurer to implement or ensure adherence to board policies on governance, risk management, internal controls, financial reporting and compliance, and recommend improvements where necessary.
- These control functions should include a risk management function, actuarial function, a compliance function and an internal audit function.
- The independence and effectiveness of the control functions should be promoted:
 - The control functions should have authority and status within the insurer
 - The control functions should be well-resourced and be staffed by persons possessing appropriate integrity, competence, skills, expertise and relevant experience and professional qualifications
 - The control functions should be separate from business operations or other influences that would or might affect their ability to perform their responsibilities objectively
 - The control functions should, in addition to any internal reporting lines, have a reporting relationship with the board and any relevant committee and be able to participate in relevant board or committee meetings
 - The control functions should report their findings (including non-compliance with policies and identification of problems or emerging risks) to the board and any relevant committee on a regular basis and as circumstances warrant; if necessary, the control functions should be able to request a meeting of the board or relevant committee
 - The control functions should be able to access any persons, data, reports or documents and obtain any other information relevant for their responsibilities

- The control functions of an insurer should assess the appropriateness of the policies, processes and procedures over which they have oversight, identify and follow up on any identified deficiencies, and propose any necessary amendments.
- The control functions should be informed of and understand all relevant legal and regulatory requirements.
- The mandate, scope of activities, authority and independence of the control functions, their organisational structure and reporting lines, the relationship among the control functions, and the process for the selection of the heads of the control functions, should be clearly laid out and documented.
- The mandate and authority of the control functions should be communicated throughout the insurer.

The independence of the actuarial and internal audit functions should be especially promoted.

The external auditor and the heads of the control functions should meet periodically (at least annually) and as circumstances warrant with the non-executive members of the relevant board committee(s) or of the board without management present.

1. Risk management

- A risk management function, independent where possible, should be established to:
 - Identify, assess, monitor and appropriately mitigate risks or oversee such risk mitigation activities
 - Support the development, coordination, implementation of or adherence to risk management policies, processes and procedures throughout the insurer and report on non-compliance
 - Assess the appropriateness and effectiveness of the risk management policy, framework or strategy and of the risk management and internal control system, and recommend improvements as necessary

2. Actuary /actuarial function

- Insurers should have an actuary or actuarial function to estimate insurance risks, calculate policy liabilities and determine, or provide an opinion on, the appropriate technical provisions to cover these obligations.

a. Roles and responsibilities

- The actuary (or the actuarial function) should perform sound actuarial valuations and determine, or provide an opinion on, the appropriate level of technical provisions.
- For mutual insurers or stock company insurers with participating policyholders, the actuary² should determine, or provide an opinion on, whether the distribution of policy dividends is fair and equitable.
- The actuary or those performing the actuarial function should adhere to sound standards of actuarial practice and conduct.

² Or, equivalently, key designated persons performing the actuarial function.

b. Appointment/designation

- The actuarial function should preferably be filled by an appointed actuary. Where the board does not appoint the actuary, the board should be informed of, and have a say over, the appointment or dismissal of the actuary.
- The dismissal or resignation of the actuary should be reported to supervisors and, as appropriate or required, publicly disclosed.

c. Fitness and propriety

- The actuary should, in addition to having requisite integrity and expertise, be a member in good standing in a professional association that requires adherence to sound standards of actuarial practice, quality control and ethics.

d. Independence

- The actuary should be free of influences that may compromise his/her ability to undertake actuarial valuations in a fair and objective manner.

e. External reporting

- The actuary should be able to report to the external auditor.
- If the actuary, in the course of his or her duties, become(s) aware of any matter that has or is likely to have a material adverse effect on the insurer's financial condition, or aware that the insurer does not or is unlikely to comply with relevant requirements or standards, he/she should inform the board and the external auditor and, if no suitable action is taken, the supervisory authority.

3. Compliance

- A compliance function should be established to monitor adherence to internal policies and codes and legal and regulatory requirements of applicable jurisdiction(s).

4. Internal audit

- An independent internal audit function should be established to monitor the insurer's implementation of, and adherence to, internal controls, assess the adequacy and effectiveness of these controls, and recommend improvements.
- The internal audit function should be able to report any major findings or material problems directly to the external auditor.
- In the absence of independent risk management and compliance control functions, or as a supplement to such functions ("last line of defence"), the internal audit function may monitor the insurer's implementation of, and adherence to, governance, risk management and compliance policies, assess the adequacy and effectiveness of these policies, review and assess the risk management system, and recommend improvements, as well as report material findings or problems on these matters to the board or relevant board committee.

C. Compensation

- Compensation arrangements should promote long-term, firm-wide profitability, be adjusted for all types of risks and symmetric with outcomes, reflect the time horizon of risks and discourage excessive short-term risk taking.
- The risk management and internal control system should consider any risks arising from compensation arrangements and incentive structures.
- Compensation arrangements should appropriately remunerate those belonging to the control functions to ensure that these functions attract necessary expertise, have appropriate status within the insurer and exercise independent judgement.

D. Management structures

- Insurers should establish, as appropriate and necessary, internal organisational structures such as management committees to address specific issues on a firm-wide basis (e.g., risk management) and enhance information flows and reporting. These structures should properly integrate the views of the control functions to ensure sound decision-making.

E. Communication and reporting

- Effective communication and reporting among all the persons involved in the administration of the insurer, and with those responsible for its oversight, should be established with the insurer. Reporting should include the generation, analysis and timely transmission of relevant and accurate information and appropriate escalation mechanisms.

F. Whistleblowing

- Appropriate mechanisms should be established within an insurer so that employees (including key executives and management), their representative bodies (if any) and outside stakeholders can bring matters to the attention of the board with respect to inappropriate actions and behaviour within or by the insurer.
- Those providing this information should benefit from adequate protections and confidentiality to assure the effectiveness of such disclosure or “whistleblowing” mechanisms.

III. GROUPS AND CONGLOMERATES

A. Transparency and knowledge of structure

- Group or conglomerate (hereafter “group”) ownership, structures, arrangements and relations should be transparent to all entities within the group and related shareholders as well as to external stakeholders, and should be well understood by boards of directors and key executives.

The purpose, function and activities of all the major entities within a group, and the jurisdiction out of which they operate, should be disclosed.

B. Comprehensive view

- The boards and key executives of controlling and controlled entities within a group should have a comprehensive view of the business, operations and overall risks of the group and of the major entities within it.
- The boards and key executives of controlling and controlled entities within a group should have an understanding of any contagion risks within the group so that appropriate mitigation measures can be adopted.

C. Governance system

- A coherent, well-functioning and transparent governance system should be established within the group to ensure sound governance practices, with clear lines of responsibility and accountability across the group consistent with applicable legal requirements.
- This governance system should recognise the responsibility of the board of any insurer within a group to exercise independent decision-making and ensure the soundness and performance of the insurer.
- The control functions of the controlling entity in the group should appropriately consider a group-wide perspective in their activities and support, as appropriate and as may be requested, the control functions within controlled entities.
- The essential components of the control functions of an insurer within a group should be retained, permitting independent oversight of the insurer’s operations and the identification and mitigation of contagion risks.

D. Communication

- There should be adequate group-wide flows of information to ensure that transparency and a comprehensive view can be brought to group arrangements, operations and risks, and that the risks related to group structures can be identified and mitigated.

IV. STAKEHOLDER PROTECTION

The governance framework for insurers should ensure an appropriate protection of the interests and rights of stakeholders (including policyholders, employees, creditors, supervisors and consumers) through proper disclosure and market conduct, effective governance and redress mechanisms, and respect for the rights and expectations of shareholders (or member-policyholders) and participating policyholders.³

A. Mutuuls

1. Participation and voting

- Member-policyholders should have the opportunity to participate actively in the governance of the mutual insurer.
- Member-policyholders or their representatives should have the opportunity to participate effectively and vote in general meetings and be informed of the rules, including voting procedures, that govern these meetings.
- The election process for any representatives of member-policyholders should be fair and transparent. Adequate information should be provided on candidates for election.
- Members should be able to waive their interests in the mutual insurer by ending their insurance contract, subject to the terms and conditions of that contract.

Member-policyholders (or their representatives) should be furnished with sufficient and timely information on the date, location and agenda of general meetings and on the issues to be decided at the meeting.

Member-policyholders (or their representatives) should be given the opportunity to pose questions to the board.

All member-policyholders should have an opportunity to place items on the agenda at general meetings, subject to reasonable limitations and thresholds.

Member-policyholders (or their representatives) should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

Member-policyholders should be appropriately informed of material decisions reached at the general meetings.

Mutual insurers may seek to promote appropriate balance and diversity in the representatives elected by member-policyholders (e.g., in terms of class of insurance, occupation, age, region, gender, etc).

Mutual insurers in which representatives of member-policyholders are elected should consider efficient ways to learn the views of policyholders.

a. Election of board

- Member-policyholders or their representatives should elect the members of the board of directors.

³ In the case of insurers taking a corporate form, reference should be made to Principles II and III of the *OECD Principles of Corporate Governance* dedicated, respectively, to the rights of shareholders and key ownership functions, and the equitable treatment of shareholders.

b. Fundamental changes

- Member-policyholders or their representatives should be sufficiently informed of and make decisions on fundamental changes, such as: (i) amendments to the statutes (e.g., demutualisation, re-organisation by creating a mutual holding entity); (ii) authorisation to issue participating securities or issue bonds or subordinated instruments if this decision has a material impact on member-policyholders; (iii) the transfer of all or part of the policy portfolio.

2. Distribution of surplus

- The board or member-policyholders or their representatives should make decisions on proposals on rebates, supplementary contributions and distribution of surplus earnings.

3. Information and disclosure

- Member-policyholders should receive relevant, sufficient and reliable information on the insurer on a timely and regular basis.

Member-policyholders should have free access to the mutual's annual report.

B. Participating policyholders

1. Governance

- The board should respect the rights of participating policyholders and give due regard to their interests in its decision-making.
- Participating policyholders should be able to exercise any governance rights attached to their contract effectively and receive the information necessary to exercise such rights.

2. Dividend policy

- The board should establish a dividend policy that explains the decision-making process and principles in relation to the allocation of the participating policyholder surplus.

3. Fair and equitable allocation

- The allocation of the surplus should be done fairly and equitably with due consideration to all participating policyholders and the financial risks borne by the insurer in providing any guarantees to participating policyholder policies.

4. Disclosure

- Participating policyholders should receive relevant, sufficient and reliable information in connection with their participation rights on a timely and regular basis.

Participating policyholders should have free access to the insurer's annual report

C. Transparency and disclosure

- Insurers should accurately and clearly disclose relevant information on a timely basis in order to give stakeholders (particularly shareholders (or member-policyholders) and policyholders) a proper view of their strategy and objectives, business activities, governance, ownership structure, compensation, performance and financial position, and facilitate an understanding of the risks to which they are exposed.
- Channels for disclosure should provide for equal, timely and cost-efficient access to relevant information by users.

The main elements of disclosure should include:

- *Strategic objectives, business lines and major plans of action*
- *Financial and operating results, financial condition and solvency position, risk profile, main risk management actions, current and foreseeable risk factors, and related analysis and discussion*
- *Governance structures and policies, including: the allocation of oversight and administrative responsibilities between the board and management; selection of board members and performance evaluation process; codes of conduct; conflicts of interest; the mandate, composition and working procedures of board committees; the risk management and internal control framework; and the authority and organisation of control functions*
- *Organisational structure, including general organisational chart, business lines and management committees*
- *Board members, their expertise, qualifications, employment history, other directorships held, whether they are regarded as independent and related criteria for determining independence*
- *Key executives and their background and expertise*
- *Compensation policies and arrangements for board members, key executives and employees (including the mechanisms for ensuring alignment with long-term interests), the governance process used to determine compensation, and compensation outcomes*
- *Major share ownership structure and voting rights (if relevant) and any participation of such ownership interests in the board or key executive positions*
- *Group structures (including (i) upstream ownership and voting rights; (ii) subsidiaries and ownership stakes and voting rights retained by the insurer, including through other subsidiaries; and (iii) affiliated companies and ownership stakes and voting rights held by parties related to the insurer) and group relations and organisation, including the nature and objectives of the group and the extent to which group policies apply to the insurer*
- *Material related party transactions (including intra-group transactions).*

D. Market conduct and financial education

1. Know customer

- Insurers should assess the level of prospective clients' understanding of insurance products and risks. This assessment should apply in particular to contracts that are complex, involve commitments that are long-term or represent a substantial proportion of current and future income, or involve an important transfer of risks to policyholders.
- Where appropriate in light of the nature and complexity of the contract, insurers should seek to understand the needs, risk tolerance and risk capacities of their customers.

2. Fair treatment

- Insurers should treat their customers and policyholders fairly and follow proper standards of market conduct in all stages of an insurance contract.

3. Tailored disclosures

- Insurers should provide customers and policyholder with appropriate, relevant and specific information relating to insurance products and contracts, including coverage, benefits, obligations, charges and other matters linked to the policies.

E. Redress

- Insurers should establish fair, efficient and transparent complaint-handling and resolution policies and procedures to resolve disputes and, absent their resolution, to identify alternative avenues of redress for policyholders.
- Policyholders should have access to statutory redress mechanisms to settle disputes with insurers, at a minimum through the courts or the regulatory/supervisory authority.

PART II

ANNOTATIONS

A - RATIONALE FOR THE GUIDELINES

As financial institutions whose business is the acceptance and management of insurable risk, insurers are expected to have sound governance practices and effective risk management so that they will be in a position to provide promised benefits to policyholders (and any relevant beneficiaries) and thus fulfil their insurance function in the economy. Moreover, given that the insurance business is in many instances, due to its complexity, characterised by important asymmetries of information and potential related imbalances in power between buyers and sellers, there is an expectation that insurers will treat their customers and policyholders fairly, with appropriate internal policies, processes and procedures to ensure this outcome. Furthermore, as financial institutions accepting public funds in return for promised future payments (in the case of insurers, with a potentially longer time delay and payment being made only when an insured event occurs or, for policies involving invested funds, no necessary right of immediate redemption), insurers may have an incentive to engage in risky behaviour or practices that have short-term benefits but do not properly consider policyholder interests or, more broadly, the reputation of the industry.

Accordingly, the governance practices of insurers should be sound and in general exceed those found in most ordinary corporations. This expectation is reinforced by the prudential framework that emphasises the responsibility of insurers for managing and controlling their risks and establishing appropriate policies and practices to this end. Indeed, while various aspects of the regulatory and supervisory framework for insurance in OECD countries help to address the risks facing insurers and promote the fair treatment of customers and policyholders, thus enhancing the quality of policyholder protection and reducing default risks,¹ the corporate governance system remains a key mechanism -- on which the prudential system must rely to a considerable extent -- for ensuring sound insurer management and conduct. Insurer corporate governance is therefore a central element of the prudential framework for insurers in OECD countries, and in a number of countries is in fact expected to become an integral component of the solvency framework.

The centrality of corporate governance to a sound and well-functioning insurance sector suggests that a set of guidelines dedicated to the governance of insurers, building on the internationally recognised OECD Principles of Corporate *Governance*, would be beneficial. Such guidelines would reinforce and augment as necessary corporate governance principles generally applicable to corporations and support the objectives of the regulatory and supervisory framework for insurance. In particular, guidelines on insurer governance would place emphasis on the following elements:

- Expected prudent approach to business and financial strategies, consistent with the role of insurance in the economy and, where relevant, social security systems;
- Well developed risk culture and risk management and internal control systems, supported by effective and independent control functions;
- High level of financial expertise among board members and within senior management; and,
- Policies and procedures that ensure proper treatment of customers and policyholders (and any relevant beneficiaries), including mechanisms for redress.

Any guidelines on insurer governance should be of practical use and benefit to the industry itself, serving as a useful benchmark for good insurer governance and thus a starting point for more specific approaches and practices within insurers. Any guidelines of this nature should also be broadly consistent with relevant international core principles of insurance supervision and, to the extent possible, with principles of good governance in other financial sectors.

While the governance framework for insurers should be well-defined and be comparable to the framework for other financial institutions, there should sufficient recognition of the specificities of the insurance sector (e.g., potential for greater misalignment of interests between an insurer and a policyholder, role of actuaries in determining liabilities, possible rights of policyholders to profit distribution; see Part B below) and sufficient flexibility to take into account the characteristics of each branch of insurance activity and various forms of corporate structure: stock companies, mutual and co-operative structures and unique structures like Lloyd's.² Moreover, there should be adequate recognition of the nature, scale and complexity of the business of insurers and of the risks to which they are exposed. Finally, consideration needs to be given to the potential role of group or conglomerate structures.

B – SOME SPECIFICITIES OF THE INSURANCE SECTOR

Alignment of interests

As in the case of ordinary corporations, there may be a potential misalignment of interests between owners and managers at insurers given the difficulty in achieving perfect monitoring of management – symptomatic of the classic principal-agent problem. The nature and extent of the misalignment may vary depending on whether an entity is structured as a stock company or as a mutual insurer.³ In both cases, there is the potential divergence of interests arising from the separation of ownership from control, as managers of the insurer may pursue their own interests contrary to the interests of shareholders (in the case of stock companies) and member-policyholders (in the case of mutuals).

However, as ownership interests (be it through a share or a policy insurance contract) in mutual insurers are non-transferable and non-negotiable (cooperatives) and tend to be dispersed, market control mechanisms such as the threat of takeover, strengthened management oversight by a block of shareholders, or the use of stock options as incentive measures are limited, if not completely lacking. Thus, the discretionary power of management in mutual insurers may be more extensive than in stock companies, unless counterbalanced by some other control mechanisms. These limitations should be taken into account when elaborating an appropriate corporate governance framework for mutual insurers.⁴

Moreover, the interests of both shareholders and management combined may diverge from the interests of policyholders. This possible divergence arises from the value-maximisation objective of shareholders and management, and may take the form of inadequate technical provisions, unfair claims settlement outcomes, or inequitable profit distributions to participating policyholders. With mutual insurers, where member-policyholders are the “owners” of the insurer, the greater coincidence of interests of the insurer should help to align the interests of the insurer with policyholders. Given the potential misalignment of interests between the insurer (shareholders and management) and policyholders, some jurisdictions impose a fiduciary duty on the board to act in the best interests of policyholders; alternatively, there may be supervisory expectation that boards take into account the interests of policyholders in their decision-making.

Another source of a possible misalignment of interests lies in the potential asymmetry of information and power between policyholders and the insurer, including its management.⁵ The complexity of many insurance products and the varying duration of contracts lend themselves to various interpretations regarding contract clauses and make comparison of different insurance policies an arduous task. Information may not be reported in an easily understood fashion and individual policyholders may lack the expertise needed to sift among various technical parameters of contracts. Policyholders and insurance beneficiaries are also a dispersed group, with little power to compel insurers and their management to take certain actions; in particular, they may be in a weak position to contest the settlement of claims. Without appropriate governance standards and other safeguards that promote proper market conduct and financial education, their options may become circumscribed -- they may be left with little choice but to not take out a policy, not to renew a policy, to accept the claim payment, or to seek legal redress, which may be sub-optimal and entail high costs. With mutual insurers, there is a greater coincidence of interests between the insurer and its constituent policyholders, which should alleviate concerns.

Nature of the insurance business

In addition to potential divergences of interest, other governance issues arise in the context of specific branches of activity. Some issues may arise in life insurance, some in non-life and others in reinsurance.

Life insurance establishes contractual relations over a number of years between an insurer and the life policyholder or the latter's beneficiaries, which is similar in many respects to the fiduciary relationships of pension funds. Major problems of governance stem, *inter alia*, from an insurer's viability as a going concern, and from the behaviour of its officers. Over a long period of time, many parameters of policy pricing may change, including mortality rates for the insured, returns on investments and inflation. Given all of these uncertainties, the potential for a divergence of interest between insured and insurer over the duration of a contract is non-trivial, in the absence of other types of countervailing controls.

In contrast to life insurance, most non-life insurance business⁶ is regarded as having a shorter cycle of operation, one to three years in the majority of cases. Consequently, the potential for a misalignment of interest between policyholders and shareholders is less obvious than in the life business. The problems of governance with non-life insurers stem from information asymmetries between policyholders and insurers, and from the discretionary power of management in regard to claims settlement. These two factors may lead management to make opportunistic short-term decisions that have adverse implications for policyholders and shareholders.

In the case of the reinsurance business, the insured are themselves insurers and, thus, in principle possess adequate information and expertise about the underlying products. Partly for this reason, reinsurers may be less regulated and supervised than direct insurers in some jurisdictions whereas in others the rules of supervision (licensing, minimum solvency requirements, sanctions) are largely, if not exactly, the same as those applicable to direct insurers. Be that as it may, the international nature of reinsurers' operations makes it difficult for a single national authority to supervise them, which suggests a need for enhanced co-operation and co-ordination among different supervisors, as well as sound governance structures and internal control mechanisms for the reinsurers themselves. However, the fact that asymmetry of information is less an issue between insurers and reinsurers than between standard consumers and insurers should be kept in mind when interpreting the guidelines concerning the protection of stakeholders.

Actuarial function

More generally, the complexity of the insurance business has entailed in most OECD countries the development of a specific function – the actuary – in order *inter alia* to control and assess the solvency of insurers' activities and the accuracy of technical provisions. Although the specific position and duties of actuaries vary across jurisdictions, the role of the actuary in the corporate governance of insurers has become paramount in the life sector and is increasingly developing in the non-life sector in most OECD countries.⁷

Possible policyholder rights and role of the governance framework

Some insurance contracts give policyholders a right to participate in any profits or surplus generated by the insurance policy. These "participating policies" may generate excess returns, allowing the insurer to distribute surplus funds in the form of a policy dividend or bonus to policyholders over the life of the contract or at the end of the contract in addition to the payment of any insured benefit. In some jurisdictions, participating policyholders may have governance rights, for instance to elect a certain number of directors to the board.

In the case of stock company insurers, participating policies create a distinct policyholder constituency that has expectations regarding the allocation of any surplus. However, the allocation of any surplus is typically discretionary; the amount of the surplus to be distributed and its timing, and its allocation between participating policyholders and shareholders is generally a decision made by the board, which may lead to divergences of interest and thus a conflict between shareholders and participating policyholders. The problem does not arise in mutual insurers where shareholders and policyholders are both members and “owners” of the mutual. That said, in mutual insurers, as well as in stock company insurers, there may be questions regarding the appropriate surplus allocation among participating policyholders due to the possibly different types of participating policies and different generations of policies.

Legal requirements may provide guidance on how the surplus should be distributed (e.g., principle of equity). However, the governance framework of the insurer has an important role. For instance, control functions of an insurer (e.g., actuary, compliance) play a role in ensuring that this issue is addressed in accordance with law or, where the law does not specify this, in a fair and equitable manner. In addition, the insurer may establish a special committee to address issues relating to participating policies or special investment committee, possibly involving the actuary. Furthermore, where participating policyholder exercise governance rights, policies and procedures are established for policyholder voting and representation (in the case of stock company insurers) in shareholder meetings.

Important role of prudential regulation and supervision in the governance of insurers

The governance framework for insurers should take into account the very specific and evolving regulatory framework within which their activities are performed. As in the rest of the financial sector and because of the important role of insurance in the economy, insurance sector regulation and supervision have played a key role in shaping the governance of insurers; in fact, the regulatory framework is often a key determinant of governance standards within insurers. Governance requirements have generally been designed to improve the quality and independence of decision-making, promote sound risk management and internal control policies and procedures, and promote proper transparency, reporting and disclosure, thereby helping to reduce the incidence of default, promote market discipline and protect the interests of policyholders -- the insured and the beneficiaries of insurance contracts -- as well as any third parties that may have direct claims against an insurer under an insurance agreement.

Good governance of insurers: an essential component of the regulatory and supervisory framework

A strong prudential regulatory regime is at the forefront of the governance framework for insurers. A sound legal and regulatory environment helps to protect policyholders from most of the major potential divergences of interest between insurers and policyholders and possible resulting conflicts arising in the insurance sector, and, importantly, to promote the sector's financial soundness. Yet, as underlined above, the governance framework for insurers has increasingly become a central element of the regulatory and supervisory framework for insurance. This trend highlights the need to ensure a proper balance between developing a regulatory framework that seeks to promote high quality governance practices and providing adequate autonomy to insurers to undertake decision-making and take responsibility for developing proper governance practices. It is ultimately the board's role and function to manage the insurer, make appropriate commercial decisions and assume responsibility for the safety and soundness of the insurer, all within a context of an appropriate regulatory framework and effective oversight of insurer governance practices.

C- DETAILED ANNOTATIONS

I. GOVERNANCE STRUCTURE

The governance structure⁴ of an insurer should have an appropriate allocation of oversight and management responsibilities to provide for effective authority and efficient decision-making in the insurer, while ensuring adequate checks and balances and oversight so as to prevent poor or conflicted decision-making or mismanagement, establish proper accountability and sound incentives, and thereby protect shareholders (or member-policyholders) and the interests of policyholders and, as appropriate, other stakeholders such as employees. This allocation should be clearly established and made transparent internally and externally.

Key components of the governance structure include: the board of directors, which plays a central role in insurer decision-making and thus in its governance structure; the sub-bodies of the board, established to enhance the quality of decision-making; shareholder and policyholder oversight mechanisms (e.g., annual meetings, election of board members); the cadre of key executives who provide the interface between the board and the operations of the insurer and are essential for effective implementation of board policies and decisions; and the external auditor whose primary role is to provide assurances regarding financial reporting.

The *Guidelines* specify an appropriate allocation of oversight and administrative responsibilities in an insurer. They focus on the roles and responsibilities of the board of directors and its committees, key executives and the external auditor. Issues of shareholder rights and oversight are not addressed in these *Guidelines*, so that reference should be made to the *OECD Principles of Corporate Governance* for guidance on this aspect of the governance structure for insurers organised as stock companies.

The *Guidelines* adopt the approach taken in the *OECD Principles of Corporate Governance* by making reference only to a single “board of directors” as the governing body in an insurer. This approach recognises other types of governance structures (e.g., dual board system involving a supervisory board and management board) but assumes that the two essential governance functions – oversight and day-to-day-management – are separated. For instance, in applying the *Guidelines* to dual board systems, the “board of directors” should be interpreted to mean the “supervisory board”.⁸

Board of directors

The board of directors should provide the overall strategy and direction for the insurer and be responsible for its overall management, leaving its day-to-day management to key executives and management. The key duties, functions and responsibilities of the board of an insurer are, in many ways, similar to the board of any other corporate entity. In this respect, reference can be made to the *OECD Principles of Corporate Governance* and related annotations (specifically Principle VI), along with the *Methodology for Assessing the Implementation of the OECD*

⁴ The governance structure of an insurer refers to the organisation of decision-making and oversight and related arrangements and practices to ensure that its operations are conducted in a sound, efficient and effective manner and are aligned with the goals and objectives of its shareholders (or member-policyholders in the case of mutual insurers). The governance structure involves the assignment of rights and responsibilities across the organisation and other parties (e.g., shareholders, participating policyholders and external auditors).

Principles on Corporate Governance, for a more fulsome explanation of their responsibilities, particularly as the *Guidelines* draw on many elements of the *Principles*.

There is, however, an expectation on the part of policyholders that an insurer will be managed prudently, with sound governance practices and effective risk management, so that it will be in a position in the future to make payment on any claims, policy surrenders, or policy withdrawals. There is also an expectation that insurers will treat its customers and policyholders (including beneficiaries) fairly, with appropriate policies, processes and procedures in place to ensure this result. Accordingly, there are reasonable expectations that the governance practices of insurers will typically be superior to those found in most ordinary corporations. This expectation is reinforced by the prudential framework that emphasises the responsibility of insurers for managing and controlling their risks and establishing appropriate policies and practices to this end. These considerations suggest that the boards of insurers should be held to a high standard of governance, prudence, and business and market conduct.

In addition, as financial institutions accepting public funds in return for promised payments in the future (in the case of insurers, in the event of an insured risk occurring), insurers are subject to greater potential conflicts of interest than is the case for most ordinary corporations and thus should be held to a high standard of ethics, conduct and management of conflicts of interest. The potential for a conflict of interest may increase as the duration of the insurance contract lengthens. Provisioning requirements tend to address this conflict as funds must be set aside for future expected payouts. Actual or potential conflicts may be compounded when an insurer is part of a larger financial group, as board decision-making may place undue weight or reliance on the policies and decisions made by the board of the controlling entity.

In this context, it is worth elaborating the key elements of the role of the board of directors in an insurer, consistent with the *OECD Principles of Corporate Governance*:

Key duties: As with other corporate bodies, board members owe a duty of care and loyalty to the insurer. They should manage the insurer on a fully informed basis, in good faith, and with due diligence and care, and ensure that the interests of the insurer remain paramount in their decision-making (see Principle VI.A of the *OECD Principles*). As noted in the annotations to the *OECD Principles*, good practice considers that acting on a fully informed basis means that board members should be satisfied that key corporate information and compliance systems are fundamentally sound and support the key monitoring role of the board. These key duties take on special significance in view of the regulated status of the insurer and the related expectations of prudent behaviour, fair conduct and overall good governance.

As policyholders have a large stake in the survival of the insurer and expect fair treatment, and since insurers themselves have a business and reputational stake in ensuring proper treatment of policyholders, board members should take the interests of policyholders into account in their decision-making. In a number of jurisdictions, there is no formal requirement for the board to consider explicitly the interests of policyholders, though the supervisor authority may lay out expectations to this effect. In other jurisdictions, the board is required, by law, to take into account the interests of policyholders (or even given them priority in the event of a conflict between shareholder and policyholder interests), or such a requirement may be imposed by establishing a fiduciary responsibility for board members in respect of policyholders.

The board may also consider the interests of other stakeholders (e.g., employees, creditors, consumers, supervisory authority) in its decision-making as appropriate. Stakeholders are those with a direct or indirect right or interest in the insurer because they can affect or be affected by its actions, objectives, or policies. The board may respect the rights or interests of stakeholders due to legal requirements or contractual obligations, but may also consider their interests given broader concerns of insurer performance or, importantly in the financial sector, reputation.

Responsibilities. The board has key responsibilities in an insurer. It should provide overall strategy and direction for the insurer and establish appropriate policies and an effective governance system to achieve these objectives, and actively oversee the affairs of the insurer, ensuring that management properly implements board decisions and policies, operates the insurer efficiently and in a prudent manner, and meets board objectives. Importantly, board members should set the appropriate “tone at the top” by establishing and promoting a proper risk culture and ethical and sound control environment in the insurer and by leading by example. The board must be ready to take corrective actions if management is unable to meet implement board policies properly, fails to meet operational and strategic objectives, is poorly managing risks, is providing poor quality or incomplete information, or is otherwise failing to manage the insurer in an appropriate or adequate manner. Board members should understand these expectations and dedicate sufficient time and energy to their governance responsibilities; for instance, the board should ensure that its members have sufficient time to prepare for, and attend, board meetings, and do not have an excessive number of other mandates.

The board should ensure that it has access to accurate, relevant and timely information and can access relevant persons within the organisation as necessary or obtain external expertise. The board should also ensure that an integrated, firm-wide information and reporting system is established within the insurer. This system should be capable of providing the board, on a regular basis and as circumstances warrant, with information and analysis necessary for the board to meet its responsibilities, including information on the insurer’s financial condition, risk profile and solvency position, progress being made against strategic and business objectives and related material risks, and identification of risks that might materially affect commitments to policyholders. The board should evaluate, on a periodic basis, the quality of the information that it receives from management.

While the range of specific board responsibilities and functions is wide, it is possible, within the context of insurers, to focus on an important set of responsibilities, namely:

- *Fundamental values and objectives.* The board should establish the core values and objectives of the insurer. These values and objectives help to define the identity, orientation and strategic objectives of the insurer, and serve to establish and embed a corporate culture within the organisation, which can guide board and management decision-making and ensure a greater alignment of interests. They may also provide the anchor for ethical and sound business conduct and a proper risk culture. These values and objectives should be consistent with the expected role and activities of insurers in the financial system (and, in some countries, the social security system, including health care), and thus should be consistent with expected prudence in behaviour and risk-taking and fair conduct toward policyholders and consumers.
- *Ethics, business conduct and conflicts of interest.* Given the trust and confidence placed in insurers to manage their affairs soundly, deliver expected future benefits to policyholders and treat actual or prospective policyholders fairly, as well as the need for the board to set an appropriate ethical and professional tone at the top of the insurer, the board should establish and maintain high standards of ethics and business conduct and apply them to all those employed by the insurer. The board can do so by establishing a code of ethics and conduct that sets out appropriate standards for the behaviour of board members, management and staff, internally within the insurer and externally. These standards should address conflicts of interest (including self-dealing), corruption and other types of illegal or unethical behaviour.

Policies should also be established to identify, manage and resolve actual or potential conflicts of interest facing board members and management. These conflicts may relate matters of an individual nature (e.g., pursuit of related outside activities by board members or management; provision of, or an interest in or relationship with a person providing, goods or services to the insurer; interest in an entity with whom the insurer

is investing or conducting business), professional nature (e.g., accepting a board position in a competing company), or organisational nature (e.g., interests of controlling shareholders).

Further, appropriate policies, review procedures and safeguards should be established to govern transactions with related parties (i.e., entities that control or are under common control with the insurer, significant shareholders including family members and key management personnel), including a requirement that transactions with related parties be conducted at arm's length.

- *Governance system:* The board should establish a clearly defined and transparent governance system (subject to any legal requirements imposed on the board or management), including specification of the respective roles and responsibilities of the board and management, and should oversee the insurer's internal organisational structure. In so doing, the board can ensure that clear lines of responsibility and accountability and proper oversight and transparency are established. Boards may, for this purpose, establish a board charter that sets out the rights and responsibilities of the board or its members. The insurer may also publish a governance report that contains a description of its governance system. The governance system should be reviewed on a regular basis and as circumstances warrant and amended as necessary to ensure its effectiveness.
- *Strategy, business lines and key operations:* Board members should, with input from key executives, establish the overall strategy of the insurer, its business objectives and major plans of action. They should also oversee the insurer's business lines and product development and develop underwriting, pricing, and reinsurance strategies and policies and, with the support of the actuary, understand and review provisioning needs. The board should be implicated in any major organisational or operational decisions of the insurer, including any outsourcing of key operations or functions.
- *Risk management, internal controls and control functions:* Risk management is an essential feature of the insurance business and should be well integrated into the insurer's governance system. The board should establish a risk management framework or strategy ("risk management framework") to define the insurer's approach to risk, sets out methods for mitigating risk, identifies those responsible for its implementation and reflects expected prudent behaviour. Policies addressing underwriting and provisioning, reinsurance, investments, concentrations, asset-liability management, derivatives, reinsurance, business and operational strategies and processes (including business continuity planning and outsourcing), compliance and reputation (including group contagion if relevant) should be part of, or linked to, the risk management framework.

The risk management framework should be accompanied by an internal control framework specifying the policies, processes and procedures (including internal reporting) necessary to ensure the proper observance and execution of board strategies and policies (especially risk management, financial reporting and compliance) and identifying those responsible for implementation. The board should oversee the establishment a comprehensive risk management and internal control system that supports the implementation of board policies on risk management and internal controls. While this system should be elaborated by management, the board should monitor its implementation and ensure its overall effectiveness, soundness and integrity.

The board should ensure that appropriate control functions are established by management, charged with implementing or ensuring adherence to board policies on governance, risk management, internal controls, financial reporting and compliance,

and recommending improvements where necessary (see annotations for Part II.B). The board should oversee these control functions, including: their mandate, scope of activities, authority, independence and resources; organisational structure and reporting lines; the relationship among the control functions; the process for selecting the persons in charge (“heads”) of the control functions; and the quality and effectiveness of these functions. Policies should be established to define clearly the nature and authority of the control functions and, as determined by the board, the role of the board with respect to them.

- *Financial condition, risk profile and capital position:* The board should monitor and regularly assess the financial condition of the insurer, its risk profile and solvency position, and assess capital, borrowing and liquidity needs. The board should assess whether the insurer’s risk profile is consistent with its approach to risk, and assess any material divergences. The board should be responsible for decisions affecting the insurer’s capital structure or position (e.g., borrowing, share issuance and repurchases, dividends), subject to any necessary shareholder (or member-policyholder) approval. The board should review and approve the budgets and financial statements of the insurer and ensure that they reflect the financial condition of the insurer.
- *Selection of key executives, performance monitoring and succession planning:* The board should select key executives on a proper and fit basis and establish a well-defined succession plan, taking into consideration the insurer’s needs and objectives. The board should establish performance objectives for key executives, monitor their performance and replace them as necessary.
- *Compensation:* The board should establish compensation arrangements for board members, management and all employees that promote prudent behaviour consistent with the long-term interests of the insurer and fair conduct with respect to consumers and policyholders. The board should establish compensation based on an explicit governance process where the roles and responsibilities of those involved, including consultants and risk managers, are clearly defined and separated. Non-executive board members should play a significant role in this process.

A compensation policy should be established as the basis for compensation arrangements. This policy and related implementation measures should be submitted by the board to the meeting of shareholders (or member-policyholders) for information, with an opportunity provided for discussion. There should also be public disclosure of compensation outcomes for board members and key executives and of the mechanisms that have been established to ensure alignment with the insurer’s long-term interests.

- *Disclosure:* The board should oversee the process of disclosure and communications given the close linkages with the board’s other responsibilities and functions.

Composition and suitability: Board members should be *fit and proper* for their roles, particularly given the challenges and complexities associated with directing a financial institution such as an insurer, and the high standards of ethics and professionalism expected of board members. Board members should therefore have sufficient skills, expertise and experience to understand and oversee the activities of the insurer (including its governance processes, risk management and internal control practices, compensation arrangements and preparation of financial statements), assess the major risks facing the insurer and develop appropriate strategies and business plans. Board members should be of good character and repute and have the necessary judgement, leadership, independence and prudence to provide sound, strategic direction to the insurer and perform effective oversight – board members individually and collectively should be willing and able to challenge management when necessary.

At a minimum, conviction for fraud, theft, or other criminal or economic crimes, being the subject of disciplinary restrictions by a professional body, gross mismanagement of another entity that led to significant civil penalties, personal bankruptcy and a previous administrative decision implying the disqualification of the person from being a member of a board should be considered to be grounds for disqualification. Moreover, the insurer should promptly inform the supervisory authority of any change in board composition.

As it is likely not possible for each and every member of the board to have the specific insurance, financial, accounting, actuarial, management, or leadership expertise and skills necessary to direct and oversee the insurer effectively, the board should, collectively, have these skills and competencies. Where the board, collectively, lacks such expertise, it should seek the advice of external experts or professionals, although it should not transfer its responsibilities to such individuals; moreover, the board should identify, through a board renewal strategy, the needed skills and expertise sought from future board members. The challenges of directing and overseeing an insurer and need for a suitable mix of people with expertise and skills mean that there should be an adequate number of board members to ensure board effectiveness.

It is crucial for the board, collectively and individually, to demonstrate *independence* and exercise objective and impartial judgement. This requires board members, specifically non-executive board members (i.e., board members who are independent of management), to be free of any influences that might limit their capacity to act provide objective oversight. Independence is typically promoted by ensuring that a proportion of the board be composed of “independent” board members. Executive board members (or former management in the midst of any required “cooling off” period) are generally not considered to be “independent” given their management links⁹; moreover, any influence or conflict of interest that could compromise board members’ duties to the insurer reduce independence, such as providing any fee-based consulting, advisory, or other services for the insurer, or being an employee or board member of any company that does material business with the insurer. The board should establish transparent criteria for independence (not inconsistent with applicable legislation and regulations) and identify those board members who are considered to be independent on this basis. The criteria for independence and the identification of independent board members should be publicly disclosed. There should be a sufficiently high number of non-executive board members -- at least a majority -- to provide the basis for independent decision-making.

Unless there are compelling reasons to the contrary, the chair position of the board of directors should not be occupied by a non-independent director, such as the chief executive officer (CEO). Separation of the chair and CEO positions is an essential component of an insurer’s system of governance checks and balances, thus promoting the independence of oversight. Where these positions are not separated, the board should explain to the insurer’s supervisory authority and shareholders (or member-policyholders) the circumstances justifying the combination of these positions; moreover, there should also be an explanation of the measures that have been taken to avoid potential conflicts of interest and generally promote the integrity and effectiveness of the function of the chair of the board.

In a group or conglomerate context, the independence of the board can be further promoted by ensuring that a substantive portion of non-executive board members are independent of the group and its management (e.g., not a director or officer of an entity or a person (or family member) that has a significant interest in the insurer; not a director or officer of a separate entity under the control of the entity or person with the controlling interest; and not a director or officer of a subsidiary of the insurer).

The special context of mutual insurers should be recognised in regard to independence, as the boards of mutual insurers generally include member-policyholders of the insurer who cannot be considered to be fully independent of the insurer. However, since member-policyholders are the “owners” of the mutual insurer, the potential for a misalignment of interests that could be detrimental to the mutual insurer (and thus its member-policyholders) is

considerably lessened. That said, in some circumstances, there may be merit in having a limited number of independent directors (i.e., who are not member-policyholders) sit on the board of a mutual insurer given their particular expertise or skills or simply to introduce an independent point of view.

The board should, ultimately, prove capable of providing effective oversight of the insurer and ensuring proper overall management. Accordingly, board members should review, at least annually, *board performance* to assess the board's effectiveness and independence and identify opportunities for improvement. Board members should conduct individual and board performance evaluations (which may be self-evaluations or external evaluations), assess the structure and exercise of board leadership, review board composition and identify gaps in skills or knowledge. The board should consider making use of "director profiles" to help identify the desired characteristics of board members. The board should ensure that training programmes are established to respond to training needs.

There should be a formal and transparent process for the *nomination and selection* of board members, in compliance with any legal or insurer by-law requirements. The process should seek to identify persons with the knowledge, competencies and expertise needed by the board, while placing emphasis on the independence of prospective board members. The term of office of board members should also be specified in order to ensure proper board renewal, which can help the board to secure missing skills or expertise, obtain new sources of ideas and strategies, encourage diversity and thereby help to promote board independence.

Reporting and accountability. Board members should report on a periodic basis (at least annually) to shareholders (or member-policyholders) and other stakeholders as relevant, including participation at annual general meetings or general assemblies of shareholders (or member-policyholders). Board members are accountable to shareholders (and member-policyholders) for their performance and the general direction, management and performance of the insurer.

Key executives

Key executives, with their skills and expertise, resources and influence at their disposal, have a considerable impact on the governance, risk management and the control environment of insurers, underlining their governance role in an insurer as well as the importance of their fitness and propriety for effective insurer governance.

Key executives, comprising the most senior officers of an insurer, are the nexus between the board of directors and the operations of the insurer. They are responsible for proper implementation of board policies and decisions and are central to the internal organisation of decision-making within the insurer, but also play a critical role developing and proposing objectives, strategies and policies, developing options for board consideration and providing expert advice and guidance to the board.

Key duties. Given their extensive and important responsibilities for the direction and management of an insurer, the key executives of an insurer should be held to the same standard of duty and care as the members of the board, and should take into consideration the interests of policyholders in their decision-making as well as the interests of other stakeholders as may be identified by the board.

Responsibilities. Key executives have a range of important responsibilities within an insurer, such as: setting, with the board, the "tone at the top" by supporting a proper risk culture and control environment and by promoting and adhering to high standards of ethics and conduct; recommending and implementing board strategies, policies and decisions; identifying and monitoring the key risks facing the insurer and controlling them; ensuring that an effective risk management and internal control policy, framework, or strategy is implemented and

elaborating a comprehensive, operationally oriented risk management and internal control system; establishing control functions and ensuring their effectiveness; establishing appropriate compensation systems and incentive structures; promoting effective human resource management and planning; and, establishing an integrated, firm-wide information and reporting system, and monitoring the achievement of objectives, strategies, policies and plans approved by the board.

Fitness and propriety. The key executives of an insurer should, at a minimum, be held to the same standard of fitness and propriety as board members. However, it is reasonable, given their responsibilities, to expect that key executives have, on average, a higher degree of expertise and skills than board members, and thus should be subject to a relatively more stringent fit and proper test in this respect. In addition, the key executives should demonstrate strong teamwork and coordination, and balance in decision-making, to ensure the proper coordination and implementation of policies and effective information flows and reporting. There are risks associated with an overconcentration of authority in one key executive.

Reporting. Key executives play a critical role in ensuring that accurate, relevant and timely information is provided to the board and that board members can access relevant persons or information from within the organisation. Key executives should seek to ensure that this information is presented in a clear and intelligible manner and is well understood by board members. Key executives should develop training programmes for them as appropriate. In addition, key executives should promptly inform the board of any material matters that come to their attention and deserve or require board consideration.

Accountability. Key executives are accountable to the board of directors for their performance and the direction, management and performance of the insurer.

Board structures

The board should establish committees or other structures where appropriate to improve the effectiveness, efficiency, quality and independence of board decision-making, and enhance the oversight and governance of the insurer. While responsibilities may be delegated to board committees, overall responsibility for decision-making should ultimately reside with the board of directors, not with its committees. The board should review the performance of its committees at least annually to ensure that they are well functioning and meeting their mandates.

Mandate, authority and responsibilities of committees. The mandate, authority and responsibilities of all board committees should be clearly defined by the board, as well as their composition and working procedures. The board should consider establishing a charter for each of its committees outlining their mandate, authority and responsibilities. Information on the mandate, authority, responsibilities and composition of board committees should be publicly disclosed.

Independence. Committees of the board addressing matters where there is a potential for a conflict of interest should comprise a majority of non-executive directors in order to ensure the independence of decision-making. In some cases, where independent decision-making is particularly important (see below), board committees should, where possible, be comprised fully of non-executive board members. Within a group context, further independence can be promoted by ensuring that a majority of the board members of such committees is independent of the group and its management.

The board and its committees should pay particular attention to the independence of decision-making and take appropriate safeguard measures, in relation to reviews of or decisions on related party transactions, financial and non-financial reporting, the nomination of board

members, selection of key executives, the appointment or dismissal of the auditor or actuary, outsourcing arrangements and compensation.

Reporting. Board committees should, on a regular basis, report to the board on the conduct of their affairs and provide recommendations to the board on matters delegated to them for review and consideration.

Audit committee. At a minimum, an audit committee should be established to permit close monitoring and independent oversight of the preparation of the insurer's financial statements and related disclosures as well as of internal and external audit matters. Accordingly, the responsibilities of an audit committee should include:

- *Reviewing the financial statements and controls on financial reporting and overseeing financial regulatory reporting.* The role of the audit committee is to review the insurer's financial statements and related disclosures, discussion and analysis prior to their submission to the board. In so doing, the audit committee will review and assess the insurer's accounting policies and practices, and seek to ensure the quality and integrity of the financial statements by reviewing and assessing the insurer's internal controls over financial reporting. In addition, the audit committee may be involved in reviewing any financial or actuarial returns or reports that are prepared for the supervisory authority.
- *Engaging with the external auditor and reviewing findings.* The audit committee is the principal interface between the board and the external auditor. It should recommend the appointment of the external auditor (in some OECD countries, it can directly appoint the auditor) and seek to ensure his/her fitness, propriety and independence. The audit committee should review and approve the external audit plan and audit fees, establish criteria for non-audit services that can be provided by the external auditor and review and approve permitted non-audit services that may be provided by the external auditor. The audit plan may include a mandate to review the insurer's internal controls over financial reporting. The audit committee should review the external auditor's findings and assess their implications for the insurer's financial statements and take any necessary corrective actions. The audit committee should hold regular meetings with the external auditor without management present. The audit committee's should review the auditor's performance.
- *Overseeing internal audit and reviewing findings.* The audit committee should review and discuss internal audit plans and scope of activities, review reports prepared by the internal audit function in relation to financial reporting (and possibly other matters depending on the mandate of the internal audit function) and take any necessary corrective actions. It should hold regular meetings with the head of the internal audit function without management present. It may assist the board in assessing the design and operation of the internal audit function, ensuring its independence and effectiveness, and overseeing the selection of the head of internal audit.

In the absence of a separate board committee dealing with governance, risk management, or compliance, the responsibilities of the audit committee may also include reviewing and preparing the risk management framework or strategy (and possibly also the internal control framework) and monitoring the effectiveness, soundness and integrity of the risk management and internal control system; reviewing related party transactions; and monitoring compliance with applicable law, regulations, standards and guidance.

In addition, the responsibilities may, in the absence of direct reporting by the actuary to a separate committee or the board, include reviewing and discussing reports provided by the

actuary, and holding regular meetings with the actuary or key designated actuaries⁵ without management present. In this context, it may also assist the board in assessing the design and operation of the actuarial function and ensuring its quality and independence and should, if so mandated by the board, oversee the selection of the actuary.

In order to carry out its responsibilities, the audit committee should have unfettered access to all key executives, the head of the internal audit function, the actuary (or key designated actuaries) and other relevant persons, as well as to all relevant data, reports, documents and information.

In order to promote the independence of the audit committee, it should comprise a majority of non-affiliated board members and, to the extent possible, not include executive members.

Other committees: Insurers may establish other board committees to carry out defined tasks. Risk committees may be established to oversee the insurer's risk strategy and risk management and internal control system, and review stress testing results. Insurers may also establish remuneration committees to oversee compensation practices and compensation arrangements, nomination committees for the selection of new board members, and ethics or conduct committees to oversee codes of ethic and conduct, conflicts of interest and/or related party transactions. Investment committees may also be established to oversee the management of the insurer's investment portfolio; a separate investment committee may be established for participating policyholder funds. Asset-liability management committees may be established to oversee the matching of assets and liabilities within the insurer. Other possible committees include a governance committee, strategy committee, disclosure committee, human resource committee and a committee focused on participating policies.

Other structures: The board should consider the merits of establishing of other possible governance structures to enhance the governance of the insurer.

External auditor

The board is responsible for approving the financial statements of an insurer, which are prepared in accordance with the applicable financial reporting framework and generally accepted accounting principles. The financial statements are transmitted to shareholders (or member-policyholders) to enable them to understand and assess the financial condition of the insurer and monitor its performance. The financial statements are prepared quarterly and/or annually.

The external auditor, appointed by shareholders (or member-policyholders or their representatives)⁶, the board, or the audit committee, should certify the accuracy of the financial statements of the insurer in order to provide assurance to shareholders (or member-policyholders) that the financial statements fairly represent the financial condition and results of the insurer in accordance with the applicable financial reporting framework and accounting principles. The external audit should be conducted in accordance with high-quality standards of auditing and should include verification of the value of the insurer's policy liabilities and of the appropriateness of its technical provisions. This certification takes the form of an opinion that may be unqualified or, if financial reporting problems are found, qualified.

The external auditor should review, test and report on the adequacy of the insurer's internal controls over financial reporting to ensure that accurate and reliable financial information is being generated by the insurer. The external auditor's responsibilities may extend

⁵ See footnote 7 below.

⁶ In some jurisdictions, policyholders may have a role in the appointment of the external auditor.

to providing assurance on other matters, such as the insurer's ability to meet insurance obligations, risk management and internal control systems, reinsurance arrangements, intra-group transactions, or adherence to applicable laws and regulations, and providing reports for supervisors (e.g., supplementary financial information, ad hoc special purpose review of an insurer's operations, risk management, or financial affairs).

The external auditor should be subject to strict qualification and suitability standards in order to ensure sound and competent audits and promote proper conduct. These requirements should include membership in a professional association that requires adherence to sound standards of auditing, quality control and ethics, and which is subject to independent public oversight. The external auditor should also have the necessary actuarial skills and knowledge (or otherwise obtained through outsourcing) to verify the actuarial calculation of the insurer's policy liabilities and the appropriateness of its technical provisions.

The external auditor should be independent of the board, management and controlling shareholders in order to ensure objective and impartial judgement. The board or its audit committee should take all reasonable steps to ensure the independence of the external auditor, in appearance and in fact, and that there are no conflicts of interest that could compromise, or be seen to comprise, this independence. Independence of the external auditor helps to establish the credibility and reliability of the insurer's financial statements.

In order to address actual or potential conflicts of interest, many jurisdictions have banned or at least strongly restricted the possibility of auditors providing other services to their clients than their core auditing activity. In those cases where such limited non-auditing activity is allowed, careful attention is paid to the assessment of the specific circumstances of this task and in particular to the nature of the service provided and the systems of safeguards put in place to avoid conflict of interests. For instance, in some countries, these non-auditing services may be performed provided that the fact that there is public disclosure of the fact that the auditor is performing these activities and of the related fee(s) for these services. There may also be measures in place requiring auditor rotation, cooling off periods, etc.

The external auditor should have access to all relevant persons (including those performing the actuarial function) and information necessary to carry out his/her duties. Where the appointment of an actuary is required by a jurisdiction, he/she should be able to report to the external auditor as deemed appropriate by the actuary.

The external auditor should report his/her findings to the audit committee and discuss significant matters or disagreements therein. The external auditor should report material adverse findings on internal controls over financial reporting or material irregularities to the audit committee, as well as any findings raising questions about the insurer's viability.

The external auditor should, in addition, be able to alert the supervisory authority if he/she becomes aware of any material irregularities (accounting or otherwise), actual or likely non-compliance with applicable laws and standards, or any matter uncovered in the performance of his/her duties that has or is likely to have a material adverse affect on the financial condition of the insurer ("whistleblowing" function). In some jurisdictions, external auditors are required to inform the supervisor of an impending qualified opinion. With respect to this whistleblowing function, the external auditor should be protected by insurance legislation; absent such formal protection, the professional body of auditors should support such a whistleblowing function.

The resignation or dismissal of the external auditor should be reported to the supervisory authority and, as appropriate or as may be required, publicly disclosed. For any reporting to the supervisory authority, information should be provided as to whether there were any disagreements between the external auditor and the insurer and their nature. The appointment

of the external auditor should have a specific duration; moreover, the performance of the external auditor should be subject to a board review prior to any reappointment.

II. INTERNAL GOVERNANCE MECHANISMS

Internal governance mechanisms refer to those strategies, policies, procedures, processes and internal organisational structures that enable the insurer to operate effectively and efficiently as an operational unit and achieve strategic and operational objectives. These mechanisms relate to control, incentives, internal structures and reporting, as described below.

Risk management and internal control system

With risk management at the heart of their business model, insurers should have well-defined risk management strategies and sound and comprehensive risk management systems that are integrated into their overall system of governance, ensuring that risk identification, assessment, monitoring and mitigation are integrated into decision-making at all levels of the organisation and reflected in the insurer's overall strategies, policies and business plans. Internal controls provide the operating policies, processes and procedures to ensure proper observation and execution of board strategies and policies, and are thus necessary for, and should be integrated into, the risk management system.

While there are different ways to comprehend or describe risk management, proper risk management can be considered to rest on the following building blocks:

- *A proper firm-wide risk culture:* A robust and pervasive “risk culture” throughout the organisation provides an essential foundation for risk management. This risk culture should be internalised in all aspects of the organisation, both behavioural (including the most senior-level executives and other employees) and operational, thus enabling effective risk management across the firm at all levels. It should also reflect expectations of prudent behaviour and fair conduct on the part of insurers.
- *An appropriate risk framework or strategy, with due consideration to the interests of policyholders:* As noted above, an insurer should articulate its approach to risk by identifying its key risks, defining its willingness and desire to take on risk in pursuit of its objectives (“risk appetite”) and assessing its capacity to absorb risk. The approach should give due attention to the interest of policyholders and should thus reflect expected prudent acceptance and management of risks. The risk management framework or strategy should also elaborate policies for mitigating the identified risks and specify those responsible for implementation.
- *A sound internal control framework:* An insurer should elaborate a comprehensive framework of internal controls (including necessary internal reporting) capable of assuring the proper observation and execution of board strategies and policies. Internal controls include financial, operational and compliance controls. A sound internal control framework is essential for the successful execution of risk management and compliance with internal policies and external laws, regulations and standards. The internal control framework should identify those responsible for implementation, including any necessary segregation of duties, reporting and escalation.
- *A strong, comprehensive and integrated system of risk management and internal control:* A comprehensive, integrated and operationally oriented approach to risk management and internal control should be adopted, bringing together the main categories of risk (e.g., insurance, credit, market, liquidity, business, operational, contagion (if within a group) and reputational risks), the specific operating strategies, processes, procedures and mitigation techniques for identifying, measuring, assessing,

monitoring and mitigating these risks, and the mechanisms (including a comprehensive management information system) for ensuring effective and efficient communication flows and reporting, coordination, analysis and decision-making processes across the entire organisation. An integrated approach should be pursued in such a way as to not diminish appropriate governance checks and balances. The risk management and internal control system should consider risks arising from compensation arrangements and incentive structures. It should also involve regular stress testing and scenario analysis. Every part of the organisation should be involved in risk management and internal control, including business line, business support functions and control functions, as well as every level of the organisation, including key executives and the board. It is important for key executives to be involved in stress testing and scenario analysis and for the board to oversee such analysis.

It is possible that the overarching risk management framework or strategy, as well as the internal control framework, are fully integrated into the risk management and internal control system and are thus not separately articulated. The approach taken in the *Guidelines* suggests that a separate risk management framework or strategy may permit the board to focus on the general risk strategy and risk profile and on the key elements of risk management and risk governance within the insurer, leaving operational details and execution to management.

The board should also ensure that management takes prompt action to correct any material control deficiencies or any material risk exposures inconsistent with the insurer's desired risk profile as reflected in its risk management framework or strategy. A board process and management action plan should be established to monitor progress made to correct deficiencies. Problems may be identified through management reports, internal and external audit findings, the reports of the appointed actuary, the views and observations of the supervisory authority and other external parties such as credit rating agencies (insofar as the insurer is a publicly traded company), and the views, solicited by the board, of the insurer's external and internal auditors, legal counsel, or outside experts.

Control functions

Control functions (also known as internal oversight functions) should be established within an insurer to implement or ensure adherence to board policies on governance, risk management, internal controls, financial reporting and compliance, and recommend improvements where necessary. These control functions may also be responsible for implementing or ensuring adherence to management policies. These functions should include a risk management function, actuarial function, a compliance function and an internal audit function. Other functions may be possible (e.g., financial analysis).

The independence of the control functions should be promoted (especially actuarial and internal audit), as well as their effectiveness. In this respect, the control functions should have authority and status within an insurer and should be well resourced and appropriately expert, staffed by persons possessing appropriate integrity, competence, skills, expertise and relevant experience and professional qualifications. The control functions should also be separate from business operations or other influences that would or might affect their ability to perform their responsibilities objectively. That said, it may be beneficial for the control functions to participate as relevant in management structures (including, in a dual board system, the management board) insofar as these structures properly integrate the views of these functions to ensure sound decision-making.

In addition, the control functions should have a reporting relationship with the board and any relevant committee, as well as with key executives through internal reporting lines, and be able to participate in relevant board or committee meetings (their participation expected to be limited to those topics for which they are competent, and thus may be excluded from decision-making). The control functions should provide reports outlining their findings (including non-

compliance with policies and identification of problems or emerging risks) to the board and any relevant committee on a regular basis and as circumstances warrant. There should be appropriate procedures within the control functions to elevate identified deficiencies, problems, or issues to the level of key executives or, if appropriate, to the board; if necessary, the control functions should be able to request a meeting of the board or relevant committee. The external auditor and the heads of the control functions should meet periodically (at least annually) and as circumstances warrant with the non-executive members of relevant board committee(s) and of the board without management present.

Each of the control functions should be headed by a designated person with day-to-day responsibility for managing the control function and with authority over all staff in the control function. The insurer should inform the supervisory authority of any change of the heads of the control functions. The control function should be capable of collecting and aggregating information across the organisation, forming a comprehensive view of the activities for which the control function is responsible, identifying deficiencies (if relevant to the function) and undertaking any necessary actions or decisions. The control functions should be able to access any persons, data, reports, or documents and obtain any other information necessary to fulfil their duties (though any contact with individuals should pass through a key executive or, if relevant, the heads of the control functions if the latter are not considered to be key executives). The control functions should be well informed of and understand relevant legal and regulatory requirements.

The board should oversee the control functions, including their mandate, scope of activities, authority, independence and resources; organisational structure and reporting lines; the relationship among the control functions; and the selection of the heads of the control functions. The organisational and reporting features of the control functions should be clearly laid out and documented, possibly in a formal charter. The mandate and authority of the control functions should be well communicated throughout the insurer and their importance stressed.

The control functions of an insurer should assess the appropriateness of policies, processes and procedures over which they have oversight, identify and follow up on any identified deficiencies, and propose any necessary amendments. Any proposals to amend board policies should be communicated to the board for review and decision. The heads of the control functions should consider meeting regularly to discuss control issues given the possibilities of mutual reinforcement among control functions. Control functions may be combined as long as the integrity and authority of each function that is combined is maintained and any potential conflicts of interest arising from such combination are addressed through appropriate control procedures.

Risk management. A risk management function, independent where possible, should be established within an insurer to identify, assess, monitor and appropriately mitigate risks facing the insurer (or oversee such risk control activities); implement or ensure adherence to the board's risk management policy, framework, or strategy; and develop and ensure effective application of the risk management system (and internal control systems linked critically to risk management operations). Where risk management is conducted in part by business line functions, the risk management function should ensure adherence to the insurer's specific risk management policies, processes, procedures and mitigation techniques and verify the appropriateness of any material risk taking.

The risk management function should report on non-compliance with risk policies as well as assess the appropriateness and effectiveness of both the overarching risk management framework or strategy and the risk management system and recommend improvements as necessary. The risk management function should provide regular (or, as circumstances dictate, more frequent) reports to key executives and the board on the insurer's risk profile and details on the risk exposures facing the insurer and related mitigation actions as appropriate. The risk management function should also advise on risks relating to strategic and operational decisions,

such as corporate strategy, new product development, mergers and acquisitions, major investments, and outsourcing. Given the importance of the risk management function, its head should be led by a non-operational key executive, such as a chief risk officer.

Actuary. Actuaries play a major role, *inter alia*, as experts in the insurance risks incurred by the insurer, in controlling the quality of the information the insurer discloses to its shareholders (or member-policyholders), policyholders, and supervisory authorities, and in protecting the insured. The actuary's place and function within an insurer varies based in large part on the regulatory regime, but the trend in recent years has mainly been toward a strengthening of the powers of actuaries in both the life and non-life sectors.

Most OECD countries require life insurers to have actuary appointed by the board. However, in other countries, no such appointed position exists; by contrast, the function of the actuary is performed, on the one hand, by key executives or senior management who generally have -- but not on a compulsory basis -- actuarial skills, and, on the other hand, by the supervisory authority whose staff has actuarial skills. Nevertheless this model might be difficult to reproduce elsewhere since it requires the supervisory authority to dedicate substantive resources to maintaining a pool of well-qualified actuaries.

The model of the appointed actuary is more developed in the life sector owing to the long duration of life insurance contracts and the necessity and challenge of ensuring an appropriate level of technical provisions for such contracts. The appointment of an actuary in the life sector is therefore generally required in most OECD countries. However, the nature and complexity of insurance risks in the non-life sector, combined with the imperative of effective risk management, suggest the need for a proper appointed actuary or actuarial function in this sector. In a number of OECD countries, such a requirement already exists.

The primary role of the actuary⁷ is to estimate the insurance risks facing an insurer, calculate policy liabilities and determine, or provide an opinion on, the appropriate technical provisions to cover these obligations. The actuary may perform a number of other functions, such as product development and design, the determination of premium adequacy (in some jurisdictions, this may include a determination of premium reasonableness and fairness), oversight of underwriting and/or reinsurance arrangements, advice on risk management and investment policy, an assessment of the fairness or impact of transfers of insurance business and an assessment of the solvency position of the insurer and compliance with solvency requirements. In the context of mutual insurers and insurers with participating policyholders, actuaries provide a determination on the fair treatment of policyholders regarding the distribution of surplus through policy dividends and other benefits. The actuary should have access to all relevant data, accounts, and other information, and relevant staff, in order to carry out his/her duties. The actuary should also have a budget to engage external professional assistance as necessary.

Actuaries provide, at least annually, a statement, opinion, or report on their valuations and determinations to management, the board, shareholders (member-policyholders), policyholders and/or supervisory authority, depending on the requirements of the jurisdiction. This report (or a supplementary report) may include reporting on other prescribed matters such as premium adequacy, asset-liability management, and capital management and solvency. As with external auditors, actuaries may, in some jurisdictions, be directed by the supervisory authority to prepare a special purpose in-depth report on the insurer's financial condition and

⁷ For the purposes of these annotations, the term "actuary" can be interpreted to include the "actuarial function" and thus be comprised of individuals within an insurer (or potentially outsourced) performing actuarial tasks. Where there is no appointed actuary, there should be key designated person(s) within the actuarial function -- including the head of the actuarial function -- who assume responsibility for key actuarial duties, certify regulatory reports, and report to the board or its audit committee.

operations. In some jurisdictions, an actuary may be subject to a legal obligation to ensure that the interests of policyholders are protected.

For insurers with participating policies, actuaries may be expected to assess the fairness of the dividend policy, prepare a review of the method of allocating income and expenses to participating and non-participating business and provide a report or opinion on the dividends or other benefits provided to participating policyholders and whether they are fair and consistent with the dividend policy and fair and equitable among participating policyholders. These opinions and reports should be sent to the board.

The actuary should be subject to strict qualification and suitability standards in order to ensure sound actuarial and financial calculations and promote proper conduct. The actuary should be a member of a professional actuarial organisation with sound standards of actuarial practice, quality control and ethics. The appointment of the actuary may be subject to supervisory review. Moreover, consideration could be given to subjecting the work of actuaries to an external peer review process. The results of any such review should be made available to the board.

The actuary should be free of influences that may compromise his/her ability to undertake, objectively and impartially, actuarial calculations and determine, or provide advice on, the technical provisions. Independence of the actuary may be understood differently depending on the jurisdiction; however, in order to avoid conflict of interest, the actuary should, when undertaking actuarial calculations and determining or providing advice on technical provisions, be independent from business line management and decision-making. For instance, it would be inappropriate for the insurer's appointed actuary to be, at the same time, the insurer's chief executive officer or one of its key business line managers.

The actuary should inform the board and the external auditor if, in the course of his/her duties, he/she becomes aware of any matter that has or is likely to have a material adverse effect on the insurer's financial condition, or aware that the insurer does not or is unlikely to comply with relevant standards; if no suitable action is taken, the actuary should inform the supervisory authority. With respect to this whistleblowing function, the actuary should be protected by insurance legislation; absent this formal protection, the by-laws or policies of the insurer and, if possible, the professional body of actuaries should support such a function.

A potential trade-off in promoting the independence of the actuary is possible reduced board or management responsibility and accountability for the financial statements of the insurer and determination of the insurer's solvency. The board or management may come to rely on a perceived independent agent within the insurer - the actuary - to make certain key determinations. However, reducing the role and independence of the actuary increases the discretionary power of the board and management in the setting of technical provisions, which could prove damaging to the insurer if this power is abused and the problem is not detected by the supervisory authority. Therefore, any requirements regarding the role and independence of the actuary should be carefully considered in light of the circumstances of the market, business culture and resources of the supervisory authority in a given jurisdiction.

The removal of the actuary may be required where the actuary fails to perform adequately the required functions and duties or no longer meets fit and proper criteria. Alternatively, the actuary may resign for a variety of reasons, including possible disagreements or internal pressure. The insurer should notify the supervisory authority of any change in the actuary or change in the key persons performing the actuarial function and, as appropriate or as may be required, publicly disclose this change.

Compliance: A compliance function should be established to monitor the insurer's adherence to general internal policies and codes, such as in relation to ethics and business conduct, and to legal and regulatory requirements. The compliance function should report

material non-compliance to key executives or, as appropriate, to the board. The compliance function should undertake education and training efforts to ensure that all staff in the insurer are acquainted with internal policies and relevant external requirements. The compliance should monitor the legal and regulatory environment of applicable jurisdictions as well as evolving good practices in ethical and business conduct. The compliance function may be responsible for managing the whistleblowing arrangements (see II.F. below).

Internal audit. An independent internal audit function should be established to monitor the insurer's implementation of, and adherence to, internal controls, assess the adequacy and effectiveness of these controls and the control environment, and recommend improvements. Significant audit findings or material problems should be reported to the board (or a board committee) and, if relevant and appropriate, to the external auditor. The internal audit function, while assessing adherence to and execution of the internal control framework, should not be expected to assess the overall business strategy of the insurer.

In the absence of independent risk management and compliance control functions, or as a supplement to such functions ("last line of defence"), the internal audit function may monitor the insurer's implementation of, and adherence to, governance, risk management and compliance policies, assess the adequacy and effectiveness of these policies, review and assess the risk management system, and recommend improvements, as well as report material findings or problems on these matters to the board or a board committee.

Compensation

Compensation is an essential component of corporate governance, and in particular the insurer's internal governance. Compensation serves to attract and retain qualified board members and personnel and rewards them for their activities, and thus supports the achievement of the insurer's strategic and operational objectives. Moreover, compensation is a key component of the insurer's incentive structure and thus can serve to: (a) reinforce the alignment of the interests of the board, management and employees with the interests of the insurer (including its fundamental values and objectives) and thus, ultimately, with the interests of those controlling the insurer, be it shareholders or member-policyholders; (b) promote good governance and risk management practices and observance of the insurer's internal controls and external compliance and thus promote a proper culture of risk; and (c) promote fair conduct of employees with respect to consumers and policyholders.

However, inappropriately designed compensation practices may distort incentives and lead to risky or unethical behaviour at an individual and collective level that could put the insurer at risk (e.g. through weakened underwriting practices, riskier investment practices), be it in the short term or longer term, and lead to poor treatment of consumers and policyholders. The *FSF Principles for Sound Compensation Practices* outline principles for appropriate compensation practices, including governance of the compensation system: compensation arrangements should promote long-term, firm-wide profitability, be adjusted for all types of risks and be symmetric with outcomes, reflect the time horizon of risks and discourage excessive short-term risk taking; moreover, compensation arrangements should also appropriately remunerate those belonging to the control functions to ensure that these functions attract necessary expertise, have appropriate status within the insurer and exercise independent judgement.

Finally, the risk management and internal control system should consider any risks arising from compensation arrangements and incentive structures, and establish appropriate policies, processes, mechanisms and controls to manage and appropriately mitigate these risks.

Management structures

Insurers should consider establishing internal organisational structures, such as management committees, to ensure effective implementation of board policies, coordinate decision-making (while avoiding over-concentration of decision-making in one key executive), promote information flows across the organisation and ensure that appropriate expertise and differences of perspectives are incorporated into analysis and decision-making. Management committees (separately or in combination) dedicated to risk management, capital, internal control and investment may be established; insurers should consider establishing, at a minimum, a management committee or similar organisational structure responsible for risk management to ensure an enterprise-wide identification, assessment, monitoring and mitigation of risks. These organisational structures should properly integrate the views of the control functions to ensure sound decision-making. These internal organisational structures may also include mechanisms to promote employee participation in certain decision-making.

Communication and reporting

Effective reporting and communication within the insurer, both horizontally across the organisation and vertically, including the board of directors, is critical for the operation of the insurer, implementation of board strategies and policies including risk management, and achievement of objectives, as well as for proper oversight of the insurer. Reporting should include the generation, analysis, documentation and timely transmission of relevant and accurate information and appropriate escalation mechanisms so that critical new information can be elevated to appropriate levels, including the board. Reporting should cover all aspects of the insurer's activities and processes, including its adherence to internal policies and controls and its conduct with policyholders.

Effective internal reporting and communication can be achieved by establishing appropriate reporting channels, internal controls, organisational structures such as management committees, management information systems, analytical tools, whistleblowing arrangements (see below) and other mechanisms. Reporting should be bi-directional, ensuring that not only the board and key executives receive information, but also that all employees (and operators or consultants performing outsourced operations) can be informed of internal operations, decisions and policies, particularly those relevant to their duties and activities.

Whistleblowing

Appropriate mechanisms should be established within an insurer so that employees (including key executives and management), their representative bodies (if any) and outside stakeholders (e.g., brokers, individuals working for outsourced activities) can bring matters to the attention of the board or, as necessary, external parties (e.g., supervisory authorities), with respect to inappropriate actions or behaviour within the insurer or on the part of operators or consultants performing outsourced functions. Inappropriate actions may include illegal, unethical, or otherwise questionable conduct. Material breaches of internal controls should first be reported through established channels, but, if no corrective action is made, use of whistleblowing arrangements may be considered. Reports should be assessed in a confidential and independent manner, possibly by the internal audit or compliance function, and should be acted upon; if there are material findings, the reports should be brought to the attention of the board or one of its committees. Any person, unit, or function responsible for handling whistleblowing reports (and any appeals from a person named in an investigation) should be properly trained.

Those providing this information should benefit from adequate protections and confidentiality to ensure the effectiveness of such disclosure or "whistleblowing" mechanisms. Protections include a strong anti-retaliation policy and appropriately tailored carve-outs in confidentiality rules applicable to employees in order to permit, in special circumstances,

whistleblowing to external parties. That said, whistleblowing mechanisms should not become a channel for unfounded denunciations, so that appropriate parameters should be established to limit any misuse; moreover, an appeal mechanism should exist for those named in any investigation. Whistleblowing arrangements should be well communicated to all employees. The board or one of its committees should be responsible for overseeing whistleblowing arrangements and ensuring that they are appropriate and effective.

III. GROUPS AND CONGLOMERATES

The operation of insurers within group or conglomerate (hereafter to be referred to as “group”) structures presents opportunities and challenges for the governance of insurers, which may vary based on the degree of centralisation of decision-making, policies, functions and resources, the quality of governance practices in affiliated entities and the relationship of the insurer to affiliated entities (i.e., whether the insurer is the top-level controlling entity or, instead, a controlled subsidiary). Insurers that are a part of a financial group are increasingly likely to be subject to governance policies and practices (including risk management and internal controls) that are established at the group level and implemented uniformly across the group, involving possible group-wide control functions.

Insurers may benefit, from a governance perspective, from belonging to a group due to potential enhanced efficiencies that may be obtained from: the development group-wide policies; integration of business functions and risk management across the group; access to a wider pool of expertise and information technology platforms; rationalisation of outsourcing arrangements, whether internally across the group or externally with third parties; and other possible efficiencies from group arrangements.

However, governance challenges may arise due to a number of reasons, including: inadequate attention paid to the governance obligations of the entity (e.g., if the insurer is a subsidiary); unclear lines of authority and responsibility across the group; the potential for conflicts of interest given conflicted duties, which may manifest themselves in inappropriate related party transactions; possible contagion risks arising from intra-group arrangements (e.g., internal outsourcing arrangements, centralised liquidity management) or reputational spillovers; and a risk strategy and profile established for the group that may not be suitable for the insurer.

In this respect, some basic principles can be elaborated regarding financial groups and conglomerates:

- **Transparency and knowledge of structure:** Group ownership, structures, arrangements and relations should be transparent to all entities within the group and related shareholders as well as to external stakeholders, and should be well understood by boards of directors and key executives. Ownership patterns should be disclosed to clarify controlling interests across the group, both at the top-level and subsidiary level. The purpose, function and activities of all major entities within a group, and the jurisdiction out of which they operate, should also be disclosed to clarify the nature of operations and the applicable regulatory and supervisory framework(s). Group governance structures and inter-entity arrangements and relations should be sufficiently clear to permit an understanding of governance decision-making and of the functioning of group operations.
- **Comprehensive view:** Board members and key executives of controlling and controlled entities within a group should have a comprehensive view of the business, operations and risks of the group and of the major entities within it. The possible contagion risks should be well understood so that mitigation measures can be implemented as appropriate at the group and entity level.

- **Governance system:** A coherent, well-functioning and transparent system of governance should be established within a group to ensure sound governance practices. In this respect, it is good practice for groups to have a group-wide governance policy that, among other things, signals the importance that the group attaches to good governance at the parent level and at each of the legal entities forming part of the group. This policy may outline the competencies, oversight duties, documentation requirements and other expectations of members of boards within the group, and include rules governing the creation and operation of legal entities, including reporting processes applicable to subsidiaries and other controlled entities.

As part of this governance system, clear lines of responsibility and accountability (including any reporting relationships) across the group should also be established at both the board and management level. If there are any potential conflicts in responsibility and accountability in group governance, these should be specified, with reference to how these conflicts are resolved in a manner consistent with any legal obligations.

The system of governance for a group should recognise the responsibility of the board of any insurer within a group to exercise independent decision-making and ensure the soundness and performance of the insurer. This approach recognises the fiduciary duties of board members and the fact that it is the individual insurer, not the group, that is ultimately obliged to meet the claims of policyholders, as group support may not necessarily be forthcoming in a stress event. As noted earlier, the board should have a substantive portion of non-executive board members who are independent of the group and its management.

In this context, any group-wide policies, processes and practices may have to be interpreted differently or amended in light of circumstances specific to the insurer (including whether the insurer is the parent entity or a subsidiary) and in light of any legal obligations imposed on board members in respect of their duties toward the insurer (and possibly also toward policyholders). Moreover, group business operations and reporting lines should respect and be consistent with the governance obligations of individual insurers within a group.

Within a group setting, it is important for the control functions of the controlling entity in the group to adopt a group-wide perspective in their activities in order to ensure a comprehensive view and properly identify contagion risks. These control functions should support, as appropriate and as may be requested, the control functions within controlled entities, including any insurance subsidiaries, which may imply some degree of centralisation of control functions or reliance placed on group control functions. Such sharing of resources could enhance the expertise, efficiency, stature and independence of the control functions within a group.

However, an insurer within a group should retain control over the essential components of the main control functions (including risk management), allowing for independent oversight of the insurer's operations and for the identification and monitoring of contagion risks. An insurer must have the basic control capacities, resources and authority in order to be able to identify major problems and take action, including informing the board, particularly if a situation arises where group practices, operations and decisions put the insurer at risk. Fulfilling such basic control objectives would require, for instance, exercising adequate oversight of outsourcing arrangements with affiliated entities and related party transactions.

It should be stressed that independence of decision-making and the retention of core elements of control functions at an insurer within a group should not provide grounds for undue risk-taking or poor governance practices that might compromise the safety of

the group or its reputation. Adequate group-level oversight and controls (possibly supported by group-level control functions as noted above) are needed to ensure sound decision-making and governance practices within a group.

- **Communication:** Group-wide flows of information should be promoted so that transparency and a comprehensive view can be brought to group arrangements, operations and risks, and so that the risks related to group structures can be appropriately identified and mitigated.

IV. STAKEHOLDER PROTECTION

Mutuals

Mutual insurers play a large role in the insurance sector. Mutual insurers usually take two different legal forms: a mutual or a cooperative. A cooperative is a capital stock entity whose shares are generally held by its employees or customers (policyholders in this case). The main difference with a stock company is that the shares of a cooperative cannot be negotiated and therefore the entity cannot be quoted. By contrast, a mutual is generally an entity without capital, hence, in most cases,¹⁰ without shares or shareholders, and managed collectively by its policyholders. As mutual insurers, whether in the form of a cooperative or mutual, generally do not have any external capital or shareholders, each member-policyholder is an “owner” of the mutual. In this manner, the interests of member-policyholders and the “owners” of the mutual insurer are fully aligned, unlike the case for stock company insurers where the interests of shareholders and policyholders may diverge.

While mutual insurers have a distinct legal form, they share the same fundamental governance challenge of stock companies, namely how best to delegate the day-to-day management of the entity to a group of managers to ensure efficient operations, while maintaining overall strategic control and overall management of the entity, with all the agency problems that separating management from control can entail. Accordingly, many of the instruments, procedures, principles and rights developed or established in the context of the stock company model apply equally to the mutual model. In this respect, some of the principles found in the *OECD Principles of Corporate Governance*, namely Principle II (“rights of shareholders and key ownership functions”, particularly sub-principles II.B and II.C) and Principle III (“equitable treatment of shareholders”, specifically sub-principle III.C) are relevant to mutual insurers. More generally, the governance concepts, issues and challenges relevant to stock company insurers, and many of the solutions, are generally applicable to mutual insurers, hence the relevance of these *Guidelines* for mutual insurers.

That said, for the purposes of these *Guidelines*, certain core elements of the governance of mutual insurers should be highlighted. These elements relate to: (a) voting and participation in the governance of the mutual insurer; (b) distribution of the surplus; and (c) information and disclosure. These elements take on prominence in light of the direct role played by policyholders in the governance of the insurer, but also in light of a possible governance challenge for mutual insurers -- namely how to ensure effective oversight and control over management, proper information flows and, more generally, effective member participation in the governance of the mutual insurer when the “ownership” base is widely dispersed and potentially disinterested in governance matters, and when there is limited external scrutiny and market discipline.

Regarding voting and member participation in governance, the election of the board of directors of mutual insurers is generally organised in one of two ways: a direct model and indirect model. In the former, members of the mutual insurer (member-policyholders) directly elect the board of directors and can participate in the general meetings of the mutual insurer. In the latter model, the member-policyholders elect member representatives who then, in turn, elect the board of directors and participate in general meetings as delegates of member-

policyholders; in this case, the views of members are indirectly represented through these representatives.

Whatever model is in place, member-policyholders should have the opportunity to participate actively in the governance of the mutual insurer and, either directly or indirectly through a representative, participate and vote in its general meetings and elect the board of directors. Their role is particularly important in the context of any fundamental changes to a mutual insurer (e.g., change in governing by-laws), when an appropriately high quorum should be required. In order to promote effective member-policyholder decision-making on governance matters and facilitate the monitoring of the affairs of the mutual insurer, member-policyholders should receive relevant information on the insurer on a regular and timely basis and have free access to the mutual's annual report.

It should be noted that these specific guidelines address only the protection of policyholders with governance rights. However, in some mutual insurers, there may be policyholders with policies to which no governance rights are attached. These specific guidelines could apply to stock companies operated on mutual grounds, as in the case of Sweden. These are usually owned by other financial institutions or organisations and do not distribute profits to shareholders; instead, their surplus is handled in the same way as in mutual insurers.

Participating policyholders

Some insurance contracts give policyholders a right to participate in any profits or surplus generated by the insurance policy. Premiums paid under these "participating policies" are paid into the insurer's general fund or into a special fund (or into special "par" accounts) for participating policyholders and are invested by the insurer. These policies may generate excess returns, allowing the insurer to distribute surplus funds, in the form of a policy dividend or bonus, to policyholders over the life of the contract or at the end of the contract in addition to the payment of any insured benefit. Policy dividends are reviewed and approved by the board and aim to be consistent with the insurer's solvency position as well as comply with regulatory requirements. In some jurisdictions, participating policyholders may have governance rights, for instance to elect a certain number of directors to the board.

In the case of stock company insurers, a portion of the policyholder surplus may be distributed to shareholders as the insurer may have incurred risks in offering policy guarantees. For such insurers, participating policies create a distinct policyholder constituency that has expectations regarding the allocation of any surplus. However, the allocation of any surplus is typically discretionary; the amount of the surplus to be distributed and its timing, and its allocation between participating policyholders and shareholders is generally a decision made by the board on the advice of senior management. This may lead to a conflict between shareholders and participating policyholders.

To address this issue, there are, in many jurisdictions, legal requirements on how to distribute the surplus (e.g., principle of equity). The control functions of an insurer (e.g., actuary, compliance) play a role in ensuring that this issue is addressed in accordance with law or, where the law does not specify this, in a fair and equitable manner. The potential conflict does not arise in mutual insurers where shareholders and policyholders are the same -- both members of the mutual and its "owners". That said, in mutual insurers, as well as in stock company insurers, there might be questions regarding the appropriate surplus allocation among participating policyholders due to the possibly different types of participating policies and different generations of policies.

Given the nature of participating policies, the board should give due regard to the interests of participating policyholders in its decision-making. For example, where participating policies represent a large share of a stock company insurer's business, the board may establish a special committee to address issues relating to participating policies, possibly involving the actuary. The

board may also establish a special investment committee, also possibly involving the actuary, to review and monitor investments relating to the participating policy business.

In addition, the board should ensure that participating policyholders are able to exercise any governance rights attached to their contract. The board should ensure that there are appropriate policies and procedures for policyholder voting and representation (in the case of stock company insurers) in shareholder meetings. In many jurisdictions, the legislative framework for insurers provides a legal basis for these governance policies and procedures.

In order to promote transparency in decision-making and minimise the discretionary nature of decision-making surrounding the allocation of the surplus, the board should establish and publish a formal dividend policy. A clear, understandable and transparent process and set of principles for the surplus allocation decision should help to guide participating policyholder expectations, address potential conflicts of interest on the part of those making the allocation decision and ensure that participating policyholders are treated fairly.

The board should, in regard to the allocation of the surplus, distribute it fairly and equitably, with due consideration to all participating policyholders and any financial risks borne by the insurer. The actuary plays an important role in proposing or approving a fair and equitable allocation of the surplus.

Finally, participating policyholders should receive relevant, sufficient and reliable information in connection with their participation rights on a timely and regular basis and have free access to the insurer's annual report.

Transparency and disclosure

Transparency and disclosure is essential not only for controlling parties (e.g., shareholders or member-policyholders) to enable proper monitoring and oversight, but also for stakeholders such as policyholders who rely on the insurer for the payment of any indemnities or benefits and for the broader public in light of the regulated nature of the insurance industry and the important role of the insurance industry in economic and social development.

Insurers should, subject to applicable laws and regulation including those relating to privacy and confidentiality, accurately and clearly disclose relevant information on a timely basis in order to give stakeholders (including shareholders (or member-policyholders) and policyholders) a proper view of their strategy and objectives, business activities, governance and ownership structure, compensation, performance, and financial position and facilitate an understanding of the risks to which they are exposed. Disclosures on risk exposures and risk management should also be provided.

Channels for disclosure should provide for equal, timely and cost-efficient access to relevant information by users.

Market conduct and financial education

Consistent with the expectations of consumers and policyholders, and as means to promote confidence in insurers (particularly for long-term insurance policies), an insurer should follow sound practices of market conduct and treat their customers and policyholders fairly in all stages of an insurance contract, from solicitation to claims settlement. Such conduct can be supported by the insurer's culture, codes of ethics and business conduct, policies and procedures, internal controls, the activities of control functions, and communication and education to relevant persons within the insurer. It should also be reflected in the decision-making of key executives and board members.

Insurers should also play a role in the financial education of consumers and policyholders, as outlined in the OECD *Recommendation on Good Practices for Enhanced Risk Awareness and Education on Insurance Issues*: “The role and responsibilities of all insurance market players in the financial education process should be clearly defined and promoted and should become part of their good governance with respect to their policyholders and/or customers”. In this respect, insurers should seek to establish mechanisms to support the assessment of the level of clients’ understanding of insurance products and risks, particularly in the case of contracts that are complex, involve commitments that are long term or represent a substantial proportion of current and future income, or involve an important transfer of risks to policyholder.

Insurers should provide customers and policyholder with appropriate, relevant and specific information on prospective or actual insurance products and contracts, including coverage, benefits, obligations, charges and other matters relevant to the sale and execution of the policies.

Redress

Policyholders should have access to statutory redress mechanisms to settle disputes with insurers, at a minimum through the courts or the regulatory/supervisory authority. The establishment of alternative, informal redress mechanisms, such as internal dispute procedures, internal ombudsmen and independent arbitrators within insurers, should be encouraged to complement these formal channels. In lieu or in addition, an arbitrator or ombudsman may be set up by the industry to resolve policyholder disputes. Informal redress channels may lead to a more cost-effective and rapid resolution of disputes. Litigation, while potentially effective in sanctioning mismanagement, can be very costly for individual consumers, though it may be appropriate in the case where an entire group (e.g., employment association) is affected.

Policyholder complaints may indicate systemic weaknesses in insurer governance and thus may represent potential operational risk exposures. Insurers should register and monitor policyholder complaints, carefully analyse the reasons for their occurrence and identify any necessary remedial actions.

NOTES

- ¹ Prudential regulation and supervision may intervene at the various levels at which conflicts might arise between insurers and the insured. For instance, the problems of information asymmetry and consequent risks of adverse selection when contracts are taken out, and throughout their lifetime, are being potentially reduced by the development of contract law, compulsory insurance and (prior or ex post) pricing review in the OECD countries. Risks or uncertainties regarding the insurer's capacity to meet its commitments over the long term, which characterise life insurance in particular, are limited by the development of regulations on licensing, fit and proper management, solvency and insurer investments. In addition, to preserve policyholder rights in the event of an insurer bankruptcy, many OECD countries have instituted general or specialised policyholder protection funds. Finally, in the event an insurance entity falters or fails, the regulations of the OECD countries stipulate rehabilitation or sanction procedures at a variety of levels, specifying the potential means of redress available to policyholders, as well as any liability of the officers and directors of the entity in question.
- ² In order to take account of these different types of ownership, they will be referred to as "insurer" in the rest of the document and in the Guidelines.
- ³ Mutual insurers may actually take two different legal forms: a mutual or a cooperative. A cooperative is a capital stock entity whose shares must be held by its employees or customers (policyholders in this case). The main difference with a stock company is that the shares of a cooperative cannot be negotiated and therefore the entity cannot be quoted. On the other hand, a mutual is an entity without capital, hence without shares or shareholders. A mutual has no owner as such but is managed collectively by its policyholders. Mutuals cannot thus be redeemed or quoted. In the rest of the document, the wording "mutual insurer" will be generally used to reflect the situation of both legal status -- mutuals and cooperatives -- although some adaptations are specified when relevant.
- ⁴ In spite of a trend towards demutualization in the 1980's and 1990's and the formation of mutual holding companies, the insurance market is still the part of the financial sector with the largest presence of the mutual legal form. Some classes of business are handled almost exclusively by this type of corporate structure, which seems best suited to cover certain specific risks. This is the case, for example, with ship insurance in the United Kingdom, much of which is written by mutual insurers.
- ⁵ It may be noted that the insurer is also in a situation of information asymmetry vis-à-vis the potential policyholder, not knowing the latter's degree of risk aversion, real exposure to risk or behaviour in the event of becoming insured. From this lack of information stem the well-known problems of adverse selection and moral hazard—problems which insurers endeavour to alleviate through experience, better differentiation of policies in order to profile applicants, deductibles and co-insurance arrangements.
- ⁶ Apart inter alia from medical indemnity and public liability which are considered long-tail business.
- ⁷ For further background, see detailed annotations to the Guidelines in respect of the actuary.
- ⁸ As the Guidelines suggest the desirability of a clear separation of board and management functions (including the separation of the chair and CEO), a dual-board system would be consistent with the approach taken under the Guidelines insofar as the supervisory board in a dual-board system is able to provide strategic direction to the insurer and oversee the activities of the management board.
- ⁹ Under a dual-board system, all members of the supervisory board are non-executive.
- ¹⁰ In Finland, mutual insurers typically have guarantee capital and, consequently, guarantee shares. Owners of guarantee shares usually have voting rights at the annual general meeting based on these shares. Holders of guarantee shares may not always be policyholders.