

March 25, 2021

Dr. Victoria Saporta
Chairperson

Mr. Jonathan Dixon
Secretary General

International Association of Insurance Supervisors (IAIS)
Centralbahnplatz 2
CH-4002 Basel
Switzerland



Re: Draft Application Paper on Supervision of Control Functions

Dear Dr. Saporta and Mr. Dixon:

The Institute of International Finance (IIF) and its insurance members are pleased to respond to the IAIS's public consultation on the Draft Application Paper on Supervision of Control Functions (Draft Application Paper). We appreciate the IAIS's work on developing a supervisory framework for control functions and the important role that supervisors play in assessing the effectiveness of an insurer's control functions. We further agree that control functions are a crucial element of risk management and internal control systems that require appropriate levels of independence, stature, and resources.

Overarching Comments

In light of the different business models and organizational structures among insurers, we appreciate the focus on proportionality and flexibility in the Introduction to the Draft Application Paper. Differences in jurisdictional approaches call for a degree of flexibility in the supervisory framework for effective control functions. In this response, we would like to draw attention to the following considerations:

- We note statements in the Draft Application Paper where proportionality and flexibility could be better reflected, particularly in the discussion of outsourcing.
- In general, we encourage the IAIS to take a more risk-focused approach to the supervision of control functions. A risk-focused approach tailors supervision in a manner that is appropriate to the nature, scale, and complexity of the insurer's operations and risks without undue reliance on size as a proxy for riskiness.
- We encourage the IAIS to incorporate a more outcomes-based approach throughout the Draft Application Paper. An outcomes-based approach is consistent with the Insurance Core Principles; as noted in Paragraph 5 of the Draft Application Paper, supervisors have the flexibility to tailor their implementation of supervisory requirements and their application of insurance supervision to achieve the outcomes stipulated in the Principle Statements and Standards.
- For instance, an outcomes-based approach should be reflected in the discussion on where in the organizational structure the control functions reside (e.g. Paragraph 23 and the first bullet of Paragraph 25). Similarly, an outcomes-based approach should be reflected in the discussion of how supervisors ascertain whether an insurer's control functions are independent or have the appropriate stature (e.g. Paragraphs 18 and 19). We encourage the IAIS to guide supervisors to focus on the outcomes of control function activities, rather than on subjective perceptions of the

control function personnel. Focusing on the assertiveness or ‘strength’ of the control function personnel could imply that an adversarial relationship is needed between Key Persons in Control Functions and first line management in order to be effective (see e.g. Paragraphs 25 and 26). In reality, the true test of the effectiveness of the control function is whether the organization is governed and managed in a prudent, sustainable manner that does not give rise to conduct or reputational issues that can undermine organizational integrity. In a well-managed and well-governed organization, the control functions can better support these positive outcomes if they adopt a collaborative and constructive approach in their dealings with first line management.

Paragraph 26 also contains statements that could imply that supervisors should assume that first line management will be overly focused on profitability and production without due regard to risks. As the IAIS makes reference to in the Draft Application Paper, the Institute of Internal Auditors (IIA) has updated the Three Lines of Defense, which are now referred to as the Three Lines Model (Three Lines Model).¹ According to the updated Three Lines Model, the first line has the responsibility for managing risk. The second line provides assistance with managing risk, and second line roles can focus on specific objectives of risk management. The third line provides independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management. We would encourage the IAIS to restate and clarify Paragraph 26 using the language of the IIA Model, which reflects the need for the three lines to be properly balanced as part of the prudent governance and management of the organization.

As elaborated below in our comments regarding independence of control functions, we encourage the IAIS to consider the benefits of a more active control function role in executive decision making. Allowing the control functions to have a ‘seat at the table’ in first line management discussions allows Key Persons in Control Functions to provide valuable input at an early stage of the deliberation of a proposed course of action. Early discussion among first line management and the control functions can prevent a situation in which the control functions call for substantial changes in an initiative after significant planning and implementation efforts have already been underway. A more collaborative environment can prevent unnecessary conflicts between first line management and the control functions. Collaboration should not be equated with a lack of ability to challenge first line management.

The Draft Application Paper should include definitions for some additional terms, or an elaboration of the scope of some of the terms already included in the IAIS Glossary. For instance, the term “Senior Management” is defined in the Glossary, but greater specificity as to the scope of the functions conducted by senior management in each of the three lines would add clarity to the Draft Application Paper.

Role of Control Functions

We encourage the IAIS to more fully reflect the updated IIA Model² in its supervisory guidance in order to better acknowledge some of the significant revisions relating to structure and independence, including:

- The adoption of a principles-based (versus rules-based) approach allowing organizations to adapt the Three Lines Model to their objectives and circumstances. For example, the IIA states that how

¹ IIA “The IIA’s Three Lines Model-An Update of the Three Lines of Defense,” July 2020, www.global.theiia.org/about/about-internal-auditing/Public%20Documents/Three-Lines-Model-Updated.pdf.

² References are to page 9 of the Three Lines Model, Applying the Model, Structure, roles and responsibilities.

an organization is structured and how roles are assigned are matters for management and the governing body to determine.

- A shift from describing first and second lines based on functions to describing these lines based on roles. For example, the IIA states that functions, teams and even individuals may have responsibilities that include both first and second line roles.
- The IIA's focus on monitoring, advice, guidance, testing, support, and challenge in the second line risk management roles and the statement that second line roles are part of management's responsibilities and are never fully independent from management, compared to the IIA's emphasis on independence in the third line internal audit role.

We recommend a rephrasing of the description of the third line of defense in Paragraph 12, consistent with the IIA Model, as follows:

The third line is the internal audit function, which is responsible for providing independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management.

Paragraph 13 provides a good description of the first and second line roles of the actuarial function. It may be useful to cross reference or further elaborate this discussion in Section 6.2, which addresses in more detail the combination of control and operational functions. We would recommend replacing the final sentence of Paragraph 13 with the following: *Similarly, as regards pricing, the role of the actuarial function as part of the second line of defense should be limited to reviewing and providing recommendations regarding pricing.* There is independence between the underwriting and reserving functions, with individuals on different teams reaching their conclusions independently.

Independence of Control Functions

We have provided in our Overarching Comments our view that an outcomes-focused approach to observations regarding the independence of control functions is optimal to an approach that focuses on subjective observations regarding the 'strength' of Key Persons in Control Functions or on the placement of control functions in the organizational structure. We note the benefits of providing Key Persons in Control Functions with a 'seat at the table' in the strategic business discussions of first line management. As currently drafted, Paragraph 25 would require supervisors to make highly subjective determinations that would be inconsistent with an outcomes-focused approach. We would propose deleting the third bullet of Paragraph 25 or replacing it with the following:

- The roles and responsibilities of Key Persons in Control Functions are not clearly defined or potential conflicts of interests involving those persons are not properly identified or managed;

Similarly, we would propose deleting the last bullet of Paragraph 25, which would also require supervisors to make highly subjective determinations that would be inconsistent with an outcomes-focused approach.

In Paragraph 27, an example is given that the responsibilities of the risk management and actuarial functions could overlap as they relate to quantitative risk assessments. We believe that both functions play an important role in these assessments. As such, the focus of this paragraph should be on the need to clearly document and communicate the respective roles and responsibilities of each function when those functions overlap, consistent with Paragraph 62.

We propose restating the second sentence of Paragraph 30 to read as follows:

Control functions should harmonize their activities to form a coherent system, ensuring that an effective flow of information is in place. Control functions generally are risk-based and, therefore, certain lower-risk aspects of an insurer's operations may not need the explicit and direct attention of the control functions.

We question why the independence of control functions can be jeopardized in case of a combination of a control function with Senior Management functions (see Paragraph 31). We would assume that Key Persons in Control Functions are members of Senior Management. The term “operational functions” and “operational business lines” would benefit from a clear definition in the Draft Application Paper and the Glossary.

Paragraph 36 and Section 4.3 emphasize the important role of Key Persons in Control Functions in challenging senior management and raising concerns to relevant persons within the organization. This is consistent with the IIA Model's focus on communication, cooperation, and collaboration among the various first, second, and third line roles.³ As noted in the IIA Model, independence does not imply isolation. We also encourage the IAIS to revise Section 6.2 and, in particular, Paragraphs 74 and 76, to reflect that Key Persons in Control Functions can have an important role in questioning or challenging executive decision making.

In Paragraph 33, the IAIS states that it could be good practice to suggest to insurers that the predominant proportion of the remuneration of Key Persons in Control Functions be fixed. However, we would note that an excessive focus on fixed compensation could actually have an adverse impact on the insurer's ability to attract and retain staff with the requisite skills, competencies, knowledge and expertise to discharge control functions effectively. Further, remuneration tied to a company's performance, particularly remuneration with a deferred or long-term component, can incentivize Key Persons in Control Functions to implement a strong control framework. A strong control function, in turn, maximizes the likelihood of success of the franchise over the long term. More broadly, designing an effective and appropriate remuneration structure involves the consideration of a broad range of institution-specific factors. We encourage the IAIS to emphasize the primary role of the insurer's governing body in determining the appropriate structure (e.g. fixed versus variable) and level of remuneration for various roles in the organization.

Stature of Control Functions

Paragraph 39 states that, “[g]iven limited resources, some insurers choose to allocate staff with specialized skills first to business operations. This can leave a shortfall of necessary skills and expertise for the control function.” We do not believe these statements accurately reflect the control functions in the vast majority of insurers and we propose the deletion of these statements, which may lead to an inaccurate perception of the industry.

In Paragraph 42, the fourth bullet refers to suitability assessments. We propose rephrasing the first sub-bullet under that fourth bullet to read, “Supervisors may have a role in reviewing the suitability assessments that are conducted by the insurer or may have further powers for pre-approval of individuals and/or assessments;”

³ Principle Six of the Three Lines Model.

While we appreciate the need for sufficient staff in all areas of an insurer's operations, we believe that the emphasis on the size of staff in Paragraph 44 is misplaced. Indeed, too large a staff could lead to a lack of clarity as to roles and responsibilities and a corresponding lack of accountability. A large staff could also lead to a false sense of security as to the quality of the control functions for both the insurer and its supervisor(s). The comments in Paragraph 46 regarding resources being stretched thin when insurers combine responsibilities should be balanced with a reference to the potential efficiencies that can be achieved when responsibilities are combined in an appropriate manner that reflects the nature, scale and complexity of the activities and risks of the organization.

We encourage the IAIS to guide supervisors to objective criteria instead of subjective characteristics when assessing the stature of control functions as part of the overall evaluation of control function effectiveness. Objective criteria could include the resolution of control function concerns and exception reports, as noted in Section 4.3, as well as consideration of the outcomes of the control function activities – that is, do they promote an environment of prudent risk management.

With respect to Paragraph 54, we note that the regular attendance of supervisors at board or committee meetings may impede candid discussion. We recommend the revision of this paragraph to refer to occasional supervisory attendance or attendance as needed in those jurisdictions where supervisory attendance at board meetings is an established practice.

Internal Audit Function

Reporting lines can vary, depending upon the organizational and management structure of the insurer. A principles-based supervisory approach that focuses on the desired outcome (i.e. independence) allows the governing body of the insurer to implement the best structure for the organization consistent with supervisory goals.

Internal audit should not be precluded from relying on the work of other control functions. Collaboration among the control functions can facilitate a holistic view of the effectiveness of the overall risk management and compliance posture of the organization and may allow for the better identification of any gaps in risk management or compliance.

Paragraph 66 could point out the efficiencies and cost savings that can be realized when supervisors rely on the work of an effective internal audit function.

Combination of Control Functions

We encourage the IAIS to revise Section 6.2 and, in particular, Paragraphs 74 and 76, to reflect that Key Persons in Control Functions can have an important challenge role in executive decision making, consistent with our comments above. We believe that the IAIS overstates the risks of combining control functions and involving the control functions in executive decision making. We encourage the IAIS to recognize the benefits, synergies, and efficiencies, especially at group level, of a more collaborative approach among the three lines, which can lead to a more holistic view of, and approach to, risks across the group and within individual legal entities.

Outsourcing of Control Functions

In our view, a key area for greater flexibility and proportionality in the Draft Application Paper is in the discussion of outsourcing and intra-group outsourcing.

We recognize that any material outsourcing should be effectively managed by the insurer and, as appropriate, by its control functions. Supervisors should take a principles- and risk-based and proportionate approach when reviewing any material outsourced activity irrespective of the size of the insurer or insurance group. We agree with the statement in Paragraph 14 that the responsibilities of senior management and control functions are not eliminated or diminished when business activities are outsourced. With respect to Paragraphs 14, 15, and 16, we encourage the IAIS to refer specifically to the role that the first line plays in the oversight of outsourced activities, including contracting with and managing vendors and receiving vendor reports. We propose to amend the last two sentences of Paragraph 16 as follows:

The insurer is responsible for all of its activities, including those that are outsourced, and its control functions should understand and monitor risks created by outsourcing business activities. Depending on the materiality of outsourced business activities, increased supervisory attention may be warranted for the control functions with responsibilities related to those activities.

Moreover, the possible challenges created by outsourcing of control functions described in Paragraph 83 should be characterized as illustrative to avoid an impression that these challenges are commonly encountered in supervision. Outsourcing should not be equated with a loss of control or oversight; if managed properly, outsourcing can be an effective and efficient method of managing and coordinating control functions across a large group with operations across a number of markets and jurisdictions.

We encourage the IAIS to advise supervisors to concentrate their supervision of outsourcing of control functions on a review and challenge of management's decisions. Paragraph 84 could be interpreted as suggesting a broader and more direct supervisory role in selecting the outsourcing firm, which generally would not be an appropriate supervisory role.

We caution against taking an overly restrictive approach to outsourcing, as it may present an undue burden to those insurers most in need of third-party outsourcing, namely small insurers with more limited resources. A restrictive approach to outsourcing could, in fact, result in less effective control functions at those organizations.

We also point to IOSCO's *Principles for Outsourcing*, issued for consultation in May 2020.⁴ We believe that incorporation of these or similar principles may be a way to call attention to the need for proper control and oversight of outsourcing arrangements in a flexible, risk-focused and proportionate manner. We believe that a broadly similar approach to the supervision of material outsourcing arrangements across the financial services sector is a laudable goal.

In particular, Principle 5 of IOSCO's *Principles for Outsourcing* references material or critical outsourced tasks and reflects a risk-focused and proportional approach that applies heightened oversight in a proportional manner. Similarly, Principle 2 calls for the nature and detail of outsourcing contracts to reflect the materiality or criticality of the outsourced task to the business of the regulated entity. The IAIS may wish to consider greater alignment to the IOSCO approach through a greater emphasis on proportionality in the Application Paper.

⁴ IOSCO "Principles on Outsourcing Consultation Report," May 2020, www.iosco.org/library/pubdocs/pdf/IOSCOPD654.pdf.

Group-wide Control Functions

We encourage a more proportionate, risk-based, and outcomes-focused approach to the supervision of group-wide control functions in general, and to the supervision of intra-group outsourcing in particular. Overly prescriptive rules can complicate outsourcing arrangements without a commensurate benefit to effective supervision. Intra-group outsourcing can be efficient and effective in implementing control functions across a group and we encourage the IAIS to point out in the Application Paper the positive aspects such as synergies at group level and a holistic approach to risk management and control functions across jurisdictions and business lines.

With respect to the discussion of a detailed exit plan in Paragraph 84, having a full exit strategy for intra-group outsourcing may not be proportionate to the risks, or necessary based on the business conducted or the nature of the outsourcing. We propose amending the second sub-bullet under the first full bullet as follows:

Before entering into an outsourcing arrangement, request the insurer to provide an appropriate exit plan for an end to the outsourcing. The exit plan should provide for regular review.

We note that a reference to an appropriate exit plan would also align with Principle 7 of IOSCO's *Principles for Outsourcing*.

With respect to proportionality, not all insurance lines of business warrant the same level of control function oversight, and a proper prioritization of the time and attention of the control functions is appropriate. We recommend that the IAIS reflect the need for senior management to prioritize control function resources in its wording of Paragraph 89 as follows:

89. Group-wide control functions of international groups often are required to understand businesses in a range of jurisdictions as well as the legal and regulatory frameworks in which these businesses operate. The senior management of the group should allocate control function resources and efforts in a manner that reflects the nature, scale and complexity of the activities of the various businesses and the risks across the group.

Relatedly, the first bullet under Paragraph 86 should reflect the need to vary policies among entities within a group in order to reflect different activities as well as jurisdictional differences. While we appreciate the importance of high-level alignment of policy within an insurance group, this bullet could be read as suggesting that policies should be identical notwithstanding significant differences in activities and jurisdictional frameworks.

As reflected in ICP 7, the ways in which an insurer chooses to organize and structure itself can vary depending upon a number of factors. The governing body of the insurer is responsible for determining the appropriate structure, including whether a centralized or a decentralized structure is optimal and how management roles should be defined. We find the statements regarding the flaws of both a centralized and a decentralized structure in Paragraph 91 of the Draft Application Paper to be overly prescriptive and an inappropriate reflection of the control functions in most insurers. Again, the level of attention given by the control functions to each entity within the group should be consistent with the nature, scale and complexity of that entity's activities and its risk profile (i.e. principles-based supervision, with appropriate consideration of group and local requirements).

In the final bullet of Paragraph 93, further clarity as to whom this notification would be provided would be helpful.

We appreciate the opportunity to comment on the Draft Application Paper. We are available at your convenience to further discuss our response and elaborate any of the points raised herein.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Mary Frances Monroe". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Mary Frances Monroe