Matthew Bianchi and Nicholas Curmi explain how Solvency II will raise insurance industry standards even higher through rationalising corporate governance for European Insurers.

The implementation of the Solvency II Directive (the “Directive”) brings with it the introduction of an improved corporate governance regime for all European insurers under Pillar 2. As advisors to insurance companies and the wider insurance market, we welcome the Solvency II initiative as it is bound to raise the already high standards of the European insurance industry which stood firm throughout the recent financial crisis. The new regime will instill a discipline in business management and governance models for insurers and this should contribute to the overall quality of the market participants. Proper advice on the implementation of the Directive is crucial for all insurers and prospective companies.

As one of Malta’s leading law firms Ganado & Associates has buttressed the growth of the insurance and captive industry in Malta over the past few years and now advise a large number of local insurers writing business in Malta and throughout the European Union. A number of these insurers and many in the process of licensing have opted for innovative corporate structuring including the protected cell company (“PCC”) as Malta is probably the only EU member state to have introduced cell company legislation for insurers. These models have rendered the firm’s corporate governance advisory role ever more dynamic. Promoters are increasingly keen to involve their legal and regulatory consultants even during the early gestation phases of their projects to ensure that the final structures are consonant with Solvency II requirements.

The Key to Sound Governance

Solvency II identifies four essential elements that must form part of an adequate system of governance for insurers:

1. effective risk management system that identifies and manages potential risks of the insurer;
2. internal control and compliance framework;
3. independent internal audit function; and
4. an actuarial function that undertakes assessment of underwriting policy and reinsurance arrangements, amongst other tasks.

Achieving these Standards

The Board of Directors

The board of directors must ensure that the key corporate governance functions and internal controls are in place, effective, and adequately monitored, documented and reported upon. The board is also expected to delegate authority for certain functions to those at senior management level and to committees or teams who then implement the same under its guidance. It should verify that individuals holding key positions have the adequate professional qualifications, knowledge and experience to undertake their roles and responsibilities.

Most EU member state regulators including the Malta Financial Services Authority (“MFSA”) already place a significant emphasis on good corporate governance principles and current local regulation and MFSA policy already provide for this “fit and proper test” and that collectively, the board of directors will be required to possess the requisite knowledge and expertise to be able to ensure the sound and prudent management of the insurer. This provides reassurance that the board of directors and other senior executives are collectively able to offer effective supervision and management of the insurer.

NEDs

In order to maintain best corporate governance practice we strongly recommend that client companies engage at least one independent non-executive director (“NED”) to their boards as a matter of policy as an additional oversight over the executive board. Appointing Malta resident NEDs often also provides added comfort of the independence of the officer particularly when the captive or the insurer is owned and controlled by a dominant majority shareholder.
Our experience has shown that selecting the NEDs early on in the licensing process is an advantage because they are allowed to influence decisions – even if only on an informal level – relating to the governance structures from the very inception of the company.

The Compliance Officer

The appointment of a Compliance Officer is now a mandatory requirement for licensing and an essential component of internal control rules and regulations. The Compliance Officer acts as an internal control to ensure ongoing compliance with all applicable regulation. If need be the Compliance Officer may also be supported by a Compliance Committee.

The Money Laundering Reporting Officer (“MLRO”)

The MLRO is an essential requirement for life insurers, captives and PCCs. As a matter of best practice, we recommend that all insurers appoint an MLRO even if this is not mandatory.

Internal Audit

An internal auditor and internal audit committee are considered essential to good corporate governance in addition to the external auditor appointed by the shareholders. The internal audit function constitutes an independent supervisory oversight over the board, while also assessing and evaluating the adequacy and effectiveness of the other elements of its system of governance. In particular, the internal audit should act as an additional check over the internal control and compliance function of the insurer.

The Company Secretary

The company secretary also plays a key role and must also be given significant consideration. Good corporate governance dictates that the role is filled by a person well versed in local law and regulation, given the important functions performed by such individual in terms of Maltese insurance and company law.

The Rise of the Chief Risk Officer

Over recent years, we have been seeing a rise in prominence of role of CRO. The Solvency II regime and its corporate governance principles are predicated on rigorous risk management standards and the CRO is expected to be at the forefront of the new standards.

The Directive requires that risk management representation is strengthened at senior management level by ensuring that the individuals being reported to at the top have the required level of expertise to understand the significance of the risk data being report and are thus in a position to take appropriate decisions on the basis of such information. The role of the CRO is to lead the risk management system from the top, acting as a crucial link between an insurer’s risk management processes and the actual running of the firm. Appointing a CRO to the board of directors is not only conducive towards truly risk-based decision making but also sends a strong message that risk management is being given importance and priority at an executive level.

Reporting, Reporting, Reporting…

The board of directors should be able to demonstrate appropriate apportionment of responsibility with clearly delegated authority throughout the organisation and with robust management reporting and flow of information to support the delegation of authority. Compliance with applicable legislation in this respect can become complex and it is important to have suitable advice on the structuring of these information channels and the appropriate maintenance of documentation that goes with it.

Proposed EU Corporate Governance Reform

The European Commission has just recently published a green paper on the 2nd June 2010 which proposes reforms of corporate governance in financial institutions, namely banks and insurance companies, as a response to certain weaknesses that were identified in the corporate governance of financial institutions following the recent financial crisis. The consultation process for the same is open until the 1st September 2010.

The Commission importantly notes that although poor corporate governance did not actually cause the crisis, the lack of effective control mechanisms contributed significantly to excessive risk-taking, primarily because the governing boards of these companies rarely understood the nature or scale of the risks they were taking. The green paper focuses on the functioning, composition and skills of the boards of directors, the strengthening of risk management-related functions and the strengthened role for supervisory authorities and the role of shareholders, amongst other issues.

In many ways the recommendations appear to be a reflection of the fundamental corporate governance principles underlying the Solvency II Regime. Indeed, the Commission expressly
provides that the recommendations in the paper are likely to supplement other legal reforms that are to be implemented for the purpose of strengthening the financial system, including the Solvency II Directive.

Preparation is Key

Compliance with Solvency II may add a veneer of costs to operations in the short term but having the appropriate corporate governance structures in place will, in the long term, ensure the better management and superior success rate of an already prosperous industry. Good corporate governance and better risk management systems should eventually lead to a lower risk profile and thus lower capital requirements under Pillar I, which should result in lower premiums for policyholders and added capital returns for investors. The key to taking advantage of these benefits is preparation and those insurers who are well prepared on the Solvency II implementation date will arguably gain a competitive strategic advantage over the rest.

About Ganado & Associates (G&A)

G&A has extensive legal expertise in the insurance and reinsurance fields both in the international market and locally and is well positioned to assist your company whether in relation to a start-up (re)insurance operation or ongoing legal support.

Dr. Matthew Bianchi is the partner of the Insurance and Pensions Law Department at Ganado & Associates, Advocates in Malta. Dr. Bianchi has also published a number of articles relating to insurance and affiliated insurance in Malta and also lectures frequently on the subject.

Dr. Nicholas Curmi is a member of the Insurance and Pensions Law department at Ganado & Associates where he advises a wide range of insurance sector clients on their legal and regulatory needs. Dr. Curmi is also Secretary of the Malta Insurance Managers Association’s Solvency II Sub-Committee.

If you require further information, please contact Dr. Matthew Bianchi (mbianchi@jmganado.com) and/or Dr. Nicholas Curmi (ncurmi@jmganado.com) and/or

Further information about G&A, our services and copies of our previous insurance related publications can be found on our website: http://www.jmganado.com