



IAIS

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INSURANCE SUPERVISORS

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About the IAIS

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

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

The IAIS coordinates its work with other international financial policymakers and associations of supervisors or regulators, and assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB), member of the Standards Advisory Council of the International Accounting Standards Board (IASB), and partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS also is routinely called upon by the G20 leaders and other international standard setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector.

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

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1 Introduction

1. Effective control functions with necessary independence, stature and resources help insurers identify and manage risks and are considered a crucial element of the corporate governance framework. In contrast, ineffective control functions may weaken an insurer and require heightened supervisory attention. The work performed by controls functions, in particular internal audit, can also assist supervisors in identifying specific areas of concern or patterns of weakness within an insurer, informing the supervisory plan and tailoring its supervisory approach accordingly.

2. This Application Paper describes practices aimed at helping supervisors address issues related to the supervision of control functions as described in the Insurance Core Principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). In particular, the Application Paper supports observance of ICP 8 (Risk Management and Control Functions), and is relevant to ICP 5 (Suitability of Persons) and ICP 7 (Corporate Governance).

3. In addition to relevant literature and other publications, this Application Paper is largely based on the results of a survey among IAIS Members of their supervisory practices. The survey identified challenges in supervision of control functions and effective supervisory practices for addressing these challenges. This Application Paper also takes into consideration the outcome of the Peer Review of Corporate and Risk-Governance relative to the standards set out in ICPs 4, 5, 7 and 8¹.

4. The IAIS recognises the need to investigate further challenges to supervision of control functions identified in the survey, the Peer Review Process and other sources, and this paper looks to address those challenges by sharing relevant good supervisory practices.

5. As described in their Introduction, the ICPs establish the minimum requirements for effective insurance supervision and are expected to be implemented and applied in a proportionate manner. Therefore, proportionality underlies all the ICPs, including those related to supervision of control functions. Some practical examples of applying proportionality in supervision of control functions are described in this Application Paper². In general, 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.

- Implementation - proportionality allows the ICPs to be translated into a jurisdiction's supervisory framework in a manner appropriate to its legal structure, market conditions and consumers.
- Application - proportionality allows the supervisor to increase or decrease the intensity of supervision according to the risks inherent to insurers, and the risks posed by insurers to policyholders, the insurance sector or the financial system as a whole. A proportionate application involves using a variety of supervisory techniques and practices tailored to the insurer to achieve the outcomes of the ICPs. Such techniques

¹ IAIS, [Peer Review of Corporate and Risk-Governance relative to the standards set out in Insurance Core Principles 4, 5, 7 and 8](#), June 2020, p. 23.

² See, for example, Section 6 (Combination of control functions) and Section 7 (Outsourcing of control functions). See also considerations in subsection 2.2 (Mapping of control functions to the three lines of defense).

and practices should not go beyond what is necessary in order to achieve their purpose.³

6. Risk-based supervision is a related concept but distinct from proportionality; it means more supervisory activities and resources are allocated to insurers, lines of business or market practices that pose the greatest risk to policyholders, the insurance sector or the financial system as a whole.⁴

7. This Application Paper covers the following aspects of supervising control functions of insurers⁵:

- Role of control functions (Section 2);
- Independence of control functions (Section 3);
- Stature of control functions (Section 4);
- Internal audit function (Section 5);
- Combination of control functions (Section 6);
- Outsourcing of control functions (Section 7); and
- Group-wide control functions (Section 8).

2 Role of control functions

2.1 Identification and the role of control functions

8. As stated in ICP 8.2.1, an insurer's internal controls system "should ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported (both internally and externally), and compliance with laws, regulations, supervisory requirements and the insurer's internal rules and decisions."

9. A control function is defined in the IAIS Glossary as a: "Function (whether in the form of a person, unit or department) that has a responsibility in an insurer to provide objective assessment, reporting and/or assurance; this includes the risk management, compliance, actuarial and internal audit functions." A control function is considered an independent unit of the insurer with at least one natural person as head of the unit. In addition, a number of other persons may be involved and assist in the work of the control function without being ultimately responsible for its outcome. Whenever this document discusses requirements for a control function, these are addressed to the Key Persons in Control Functions⁶, unless otherwise indicated.

10. Control functions, which are part of the internal controls system, are an important element in the overall management of an insurer and are critical for promoting good risk and

³ Introduction to Insurance Core Principles, para. 9.

⁴ Introduction to Insurance Core Principles, para. 10.

⁵ According to the [IAIS Glossary](#), the term "insurer" refers to both insurance legal entities and insurance groups (including IAIGs, which are the focus of ComFrame). Therefore, unless stated otherwise, the challenges and good supervisory practices mentioned in this Application Paper apply to supervision of all insurers.

⁶ According to the [IAIS Glossary](#), Key Persons in Control Functions are persons responsible for heading control functions.

compliance culture within the insurer. The role of a control function is to “add to the governance checks and balances of the insurer and provide the necessary assurance to the Board in the fulfilment of its oversight duties”⁷. Per ICP 8, an insurer should have control functions that include: Risk Management, Compliance, Actuarial, and Internal Audit. Regardless of where a control function is situated within the insurer, it should execute its responsibilities so that the internal controls system in aggregate fulfils this need.

11. Regardless of the model adopted by an insurer, the Board should approve the authority and responsibilities of each control function to allow each control function to have the authority and independence necessary to be effective⁸. A documented and approved description of control functions’ responsibilities allows the internal audit function and the Board (or a relevant committee of the Board) to evaluate their effectiveness and identify any control gaps in the organisation. It is expected that supervisors do a similar evaluation, in addition to assessing the effectiveness of the insurer’s internal audit function.

2.2 Mapping particular control functions to the three lines of defence

12. Under the three lines of defence model⁹:

- The first line of defence consists of the insurer’s operations that own and manage the risks they generate and own the controls; and
- The control functions are within the second and third lines of defence:
 - Risk management, actuarial and compliance functions are considered the second line of defence and are responsible for assessing the appropriateness and effectiveness of the controls used by the first line.
 - The third line of defence is the internal audit function, which is responsible for “providing the Board with independent assurance in respect of the quality and effectiveness of the insurer’s internal controls framework¹⁰.” This includes providing assurances on the responsibilities of the second line of defence and the controls within the first line.

13. While well-defined on paper, the distinction between each of the three lines of defence is not always clear in practice, particularly regarding certain first and second line of defence functions. The clear separation of responsibilities helps avoid or mitigate bias, conflicts of interest or undue influence of one function on professional or business judgments of another function. This approach also ensures that the preparation and reporting of information is fair and honest. The actuarial function, in particular, has responsibilities that often straddle the first and second lines of defence. Its responsibilities related to pricing and product development are within the first line, but assessing the adequacy of the calculation of technical provisions is often considered a second line responsibility. There was a consistent view among survey participants that actuaries developing products and setting prices; and actuaries assessing the adequacy of technical provisions for those products, should be independent from each other. There was also agreement among the survey respondents on the need for independence between those calculating technical provisions and those reviewing the

⁷ ICP 8.3.1.

⁸ ICP 8.3.6.

⁹ The Three Lines of Defence model, as referenced also in ICP 8, was introduced by the Institute of Internal Auditors (IIA) in 2013. In July 2020, the IIA updated this approach with a new [Three Lines Model](#).

¹⁰ ICP 8.2.3.

adequacy of technical provisions. Similarly, as regards pricing, the role of the actuarial function as part of the second line of defence should be limited to evaluating and providing advice regarding pricing¹¹. The importance of, and reasons for, independence in this case are the same as those discussed further in Section 3.

2.3 Role of control functions when business activities are outsourced

14. The responsibilities of Senior Management and control functions are not eliminated or diminished when business activities are outsourced. On the contrary, the effectiveness of control functions is often more important precisely because business activities are outsourced and therefore may be more challenging for the insurer's Board and Senior Management to oversee. The business activities of the actuarial function is an area that is commonly outsourced, particularly by smaller insurers. This may create a number of supervisory challenges.

15. If an activity is outsourced, the control functions – within the scope of their responsibilities – have the additional tasks to check whether and how internal quality control mechanisms are applied to the outsourced activity. This includes verifying whether an internal person is involved in assessing if the external provider is carrying out the task properly and whether this internal person has the necessary qualifications and seniority for this task.

16. Supervisors should assess whether insurers understand their oversight and control responsibilities related to outsourced business activities. The insurer is responsible for all of its activities, including those that are outsourced, and its control functions should be tailored to reflect risks created by outsourcing business activities. Depending on the materiality, increased supervisory attention may be warranted for the control functions designed to oversee outsourced business activities.

17. Challenges related to control functions themselves being outsourced are covered in Section 7.

2.4 Importance of Independence and Stature for effective control systems

18. Assessing whether an insurer has an effective internal controls system in place can be more challenging than supervision of quantitative aspects of an insurer's business model. In order to make the determination that an insurer's control functions are effective, supervisors should be able to observe two key fundamental qualities – independence and stature.

19. A control function with appropriate independence and stature demonstrates both the willingness to identify weaknesses within the organisation and the capability to recommend necessary changes to the Board and Senior Management. Challenges related to assessing independence and stature, along with practices used by supervisors to address challenges, are covered in Sections 3 and 4 respectively.

3 Independence of control functions

20. As noted in ICP 8.3, as part of the effective systems of risk management and internal controls, “the supervisor requires the insurer to have effective control functions with the necessary [...] independence...”

¹¹ See ICP 8.6 and 8.6.4, 9th bullet.

21. The central role of control functions may be adversely impacted depending how these functions are considered, established, and positioned in the reporting structure within the insurer. In this regard, the supervisor should assess how well an insurer's functions align with good practices and are compliant with governance requirements.

22. Below are high-level questions supervisors should consider when assessing the independence of an insurer's control functions:

- Are the appointment, performance assessment, remuneration and dismissal of Key Persons in Control Functions subject to the approval of, or the consultation with, the Board or relevant Board Committees?
- Are reporting lines clear and do they promote independence?¹²
- Is the remuneration for Key Persons in Control Functions and their staff heavily dependent on the financial performance of the insurer, creating a potential conflict of interest?¹³
- For internal staff moves into control functions, do policies take into account potential conflict of interest? For example, having time-limited restrictions for when a person responsible for an operational function (which may involve risk-taking), is able to take over as a Key Person in Control Function?
- Are conflicts of interest identified and avoided where possible? Where they may be unavoidable, are the risks from conflicts of interest transparent and properly mitigated?
- When the control functions are combined, what is the potential impact of the combination on the independence of those control functions and whether the risk mitigants applied by the insurers are sufficient to address a potential negative influence on their independence?¹⁴

3.1 Positioning control functions in the internal structure of the insurer

23. The way in which control functions are established and positioned in the internal structure of the insurer may negatively affect their independence.

24. According to ICP 8.3.9, "insurers should organise each control function and its associated reporting lines into the insurer's organisational structure in a manner that enables such function to operate and carry out their roles effectively."

25. Signs that the independence of an insurer's control functions may be compromised include the following indicators:

- The reporting position of the Key Persons in Control Functions within the organisational structure causes interference from other areas, including business lines or other control functions (for example, limitation or denial of access to data or information);
- The Key Persons in Controls Functions are not given the opportunity to meet directly with the Board or the relevant Board committees and committee Chairs to discuss their work and identify concerns, if any;

¹² For more about reporting lines, see subsection 4.4.

¹³ For more about remuneration, see subsection 3.2.

¹⁴ For more about the combination of control functions, see Section 6 and subsection 5.1 regarding the combination of the internal audit function with the second line of defence control function.

- The Key Persons in Control Functions are involved in other tasks and projects that could introduce bias in their professional judgment to carry out their roles with independence (for example, participation in operational business lines' executive decision making);
- The control function lacks the resources and stature necessary to fulfil its responsibilities¹⁵;
- The Key Persons in Control Functions are unsuitable¹⁶ to perform the function; and/or
- The Key Person in Control Function has a weak status, or the person in charge of the first line of defence has a dominant personality.

26. Another factor that may adversely impact the independence of control functions is pressure from the first line of defence. This can happen when the business line focuses on the performance of the business and places it above the importance of effective risk management and internal controls within the insurer. Such a situation may be difficult to detect. To detect and assess the potential pressure from the business line, the supervisor should have a clear understanding of how the plans, strategies and profit targets of the business line can affect risk management and internal controls. Additionally, special circumstances could also generate pressure from the production line. For example, in a situation where an insurer is losing market share, the emphasis of the insurer could be on boosting production at the expense of weaker controls. A clear separation between execution and control is of primary importance in this case. Assessing whether the Key Persons in Control Functions feel comfortable to speak out or not may help supervisors to detect if such pressure from the first line of defence is occurring.

27. The independence of the control function may be confronted in particular when one person is responsible for more than one control function. Another situation is when different people are responsible for particular control functions, but the responsibilities assigned to control functions are not clearly defined and potentially conflict with responsibilities of other functions. For example, the responsibilities of the risk management function and the actuarial function could conflict as regards quantitative risk assessments, such as model risk. Overlapping or underlapping responsibilities could create uncontrolled or grey areas, which may result in inefficiencies or gaps that become a concern for the supervisor.

28. Another challenging situation for meeting the independence criteria could be created when a control function is overshadowed by another control function having relatively more stature and resources. This may be the case for a newly established control function, when additional time may be required to establish, embed and adequately delineate the responsibilities of the respective control function in the organisation.

29. The above mentioned challenges can be mitigated to a certain extent by following guidance 8.3.7: "The authority and responsibilities of each control function should be set out in writing and made part of, or referred to in, the governance documentation of the insurer. The Key Persons in Control Functions should periodically review such documentation and submit suggestions for any changes to Senior Management and the Board for approval, where appropriate."

¹⁵ Section 4 of this Application Paper describes issues related to stature of control functions.

¹⁶ According to ICP 5, suitability consists of two components: competence and integrity. Suitability should also be considered in the context of stature, see Section 4.

30. In case of an overlap between control functions' responsibilities, which cannot be eliminated or avoided, the supervisor should expect control functions to cooperate while maintaining their independence and be mindful of potential gaps. Under these circumstances, control functions should harmonise their activities to form a coherent system, ensuring that there are no uncontrolled areas and that an effective flow of information is in place. Clearly setting out in writing the authority and responsibilities of each control function, as described under ICP 8.3.7, provides the necessary basis to harmonise responsibilities and to identify potential overlaps or gaps between activities. However, the supervisor should be attentive to situations where actual duties and responsibilities do not match the written policies and allocation procedures.

31. The independence of control functions can be jeopardised in case of a combination of a control function with (i) other second line of defence control functions, (ii) operational functions or (iii) Senior Management functions. These particular challenges are discussed in more detail in the section 6.

3.2 Remuneration of Key Persons in Control Functions

32. According to ICP 7.6.2: "As a part of effective risk management, an insurer should adopt and implement a prudent and effective remuneration policy. Such a policy should not encourage individuals, particularly members of the Board and Senior Management, Key Persons in Control Functions and major risk-taking staff, to take inappropriate or excessive risks, especially where performance-based variable remuneration is used."

33. As indicated in ICP 7.6.10: "To better align performance-based incentives with the long term value creation and the time horizon of risks to which the insurer may be exposed, due consideration should be given to the following: [...] There should be an appropriate mix of fixed and variable components, with adequate parameters set for allocating cash versus other forms of remuneration, such as shares." A good practice could also be to suggest insurers that the predominant proportion of the remuneration of the Key Persons in Control Functions be fixed in order to prevent them from depending too heavily on variable remuneration tied to business performance.

34. Supervisors may review the insurer's remuneration policy to assess whether its scope includes Key Persons in Control Functions and that it does not improperly rely on incentives that could result in conflicts of interest.¹⁷ To avoid any conflict of interests and assure independence from operational functions, the control functions' remuneration should be defined with the approval of, or after consultation with, the Board or a relevant committee of the Board. When analysing the remuneration policy, supervisors should assess whether the remuneration of the control functions is:

- Predominantly based on the effective achievement of objectives appropriate to such control functions.¹⁸ Supervisors should pay very close attention to criteria used to determine the variable share of remuneration of Key Persons in Control Functions in order to make sure that these are closely related to their missions and not to financial results, otherwise conflicts of interest are likely to arise. These criteria should be approved by the Board and/or Senior Management;

¹⁷ ICP 7.6.

¹⁸ ICP 7.6.7, 1st bullet.

- Where applicable, not tied to the performance of any business units subject to their control or oversight¹⁹ but rather to the insurer's overall performance taking into account all relevant risks to the insurer; and
- Adequate to attract and retain staff with the requisite skills, competencies, knowledge, and expertise to discharge those control functions effectively²⁰.

4 Stature of control functions

35. While independence supports the control function's willingness to identify issues and bring them to the attention of the Board and Senior Management, stature supports their ability to do so. Appropriate stature within the organisation ensures that the control function's concerns and recommendations are given proper consideration within the insurer by the Board, Senior Management and other functions/business units. Stature within the organisation requires that those within the control function, particularly Key Persons, have the appropriate skills, competence, knowledge, experience and level of authority to effect change. It is also crucial that control functions are sufficiently staffed with appropriately trained individuals.

36. Below are high-level questions supervisors should consider when assessing the stature of an insurer's control functions:

- Do the Key Persons in Control Functions and their staff have the appropriate skills and experience needed to be effective?
- Are control functions properly staffed with the right amount and type of people?
- Does the control function, and in particular the Key Person, have the ability to effectively advise and challenge the insurer, including Senior Management and the Board?
- Does the insurer have in place adequate policies and processes to address recommendations issued by control functions?
- Are the concerns and recommendations of the control functions taken seriously and acted on in a timely manner?
- Are the findings of the control functions always or mostly positive, which could suggest those being reviewed regularly pushed back on potential issues identified?

37. Supervisors should be mindful of these signs and be ready to challenge insurers to provide evidence of each control functions' stature.

4.1 Skills and experience

38. According to ICP 5.2, in order to be suitable to fulfil their roles, Key Persons in Control Functions are required to possess competence²¹ and integrity²². In case of Internationally Active Insurance Groups (IAIGs), the group-wide supervisor also requires Key Persons in

¹⁹ ICP 7.6.7, 2nd bullet.

²⁰ ICP 7.6.7, 3rd bullet.

²¹ As per ICP 5.2.1, competence is demonstrated generally through the level of an individual's professional or formal qualifications and knowledge, skills and pertinent experience within the insurance and financial industries or other businesses. Competence also includes having the appropriate level of commitment to perform the role.

²² As per ICP 5.2.2, integrity is demonstrated generally through character, personal behaviour and business conduct.

Control Functions to have the necessary competence to fulfil their role, taking into account the complexity and international nature of the IAIG, any specific features of the jurisdictions where the IAIG operates and the risks to which it is exposed²³.

39. ICP 8 also addresses the need for control function staff to have qualifications necessary to fulfil their responsibilities²⁴. Given limited resources, some insurers choose to allocate staff with specialised skills first to business operations. This can leave a shortfall of necessary skills and expertise for the control function. It may also happen that the control function, particularly the internal audit function, is expected to carry out reviews on multiple areas while lacking all necessary expertise.

40. It can be challenging for the Board and Senior Management to assess whether the control functions have the necessary skills and expertise. Supervisors should require insurers to prioritise staffing for control functions appropriately, including for succession planning for Key Persons. This not only ensures that the control function can properly identify issues, but also supports the stature of the control function throughout the organisation.

41. Assessing a control function's stature is not straightforward for most supervisors. When questioned how they assess whether the control functions possess the stature, relevant skills, and experience needed to challenge Senior Management and operational units (in particular as business models and risk profiles of insurers evolve and make greater use of FinTech, Artificial Intelligence and outsourcing), most supervisors responded that they use a combination methods. These methods include primarily suitability assessments and on-site assessments that are either control function-specific or as part of broader governance and risk management reviews. Some supervisors focus primarily on document review, paying particular attention to assessment of governance arrangements of control functions.

42. The summaries below expand on some of the supervisory methods and focus-points adopted for assessing stature:

- Document review, including reports from control functions, or other relevant governance materials and policy documents of the insurer (eg minutes, agendas, terms of reference documents);
- Periodic reviews of the control function, including through meetings with key individuals such as Key Persons in Control Functions, and observations of Board and relevant committee meetings;
- Requirement that an external expert undertake assessments of the effectiveness of control functions when supervisors have strong concerns;
- Suitability assessments:
 - Most supervisors have a role in reviewing the suitability assessments that are conducted by the insurer or have further powers for pre-approval of individuals and/or assessments, including interviewing candidates;
 - Suitability assessments are most commonly undertaken for the Key Persons in Control Functions and in some instances the Chairs of the relevant Board

²³ CF 5.2.a.

²⁴ ICP 8.3.13

committees with oversight responsibilities. Factors typically considered include skills, education and experience; and

- Consideration of the overall skills mix, or collective suitability, of oversight bodies and the control functions.
- Reviewing the clarity of allocation of responsibilities to the senior individuals in control functions and individuals with oversight responsibilities;
- Reviewing the remuneration policy covering staff in control functions for inappropriate incentives (see also Section 3.2); and
- Reviewing the frequency and effectiveness of training for Key Persons in Control Functions and staff supporting control functions' activities.

43. Assessing whether insurers' control functions have the requisite skills and experience to be effective can be difficult for supervisors who often face the same issues. Supervisors that lack specialists like those needed to assess insurers' IT and actuarial controls, can find it difficult to challenge insurers for their lack of expertise. More broadly, a lack of expertise can make performing thorough assessments impossible. In order to address this challenge, supervisors should consider recruiting relevant specialists and/or providing specialised training to its staff. In some situations supervisors, similar to insurers, may need to rely on external resources, even if only temporarily, to fill these shortfalls in expertise.

4.2 Resource stretch

44. In addition to assessing whether control functions possess staff with the necessary skills and experience, it is also important to assess whether they have sufficient quantity of staff. Insufficient staffing, even if the available resources are highly skilled, can weaken the control function's ability to perform effectively. This can be particularly challenging for smaller insurers, where the oversight responsibilities of multiple control functions are often combined. Supervisors should be aware of these cases and the potential strain this situation can put on the control functions. If necessary, supervisors should emphasise to the Board and Senior Management the importance of appropriate staffing levels. Key Persons in Control Functions should also have the stature within the organisation to raise concerns related to staffing levels and to have those concerns appropriately addressed by the Board and Senior Management.

45. Staffing issues in control functions (and within supervisors) can also happen quickly as the adoption of new business practices and the development of new products may create new risks and require additional knowledge. Control functions and supervisors should keep themselves aware of these changes and be agile in their approach.

46. Supervisors should also be cognisant of control function resources stretched thin when insurers combine the responsibilities of multiple control functions. The Board and Senior Management should understand that a scarcity of resources is not an acceptable reason for ineffective control functions. As indicated in Section 6, control functions should not be combined if doing so results in one or more of the functions being ineffective.

4.3 Ability to challenge and raise concerns by control functions

47. Stature includes the ability of Key Persons in Control Functions to challenge Senior Management and to raise awareness of concerns to relevant persons throughout the organisation. Stature is also evidenced by the way and the urgency with which the organisation

responds to concerns raised by Key Persons in Control Functions. The supervisor may analyse meeting minutes and other relevant records to determine whether Key Persons in Control Functions are bringing concerns to the attention of the Board and Senior Management, whether these concerns are discussed at the meeting and how they are addressed. In this regard, the supervisor should expect the insurer to cover those aspects clearly in meeting minutes and other relevant records. Patterns of the Board and Senior Management ignoring the concerns of control functions, particularly if those concerns are identified by internal audit, are a key red flag for supervisors.

48. Key Persons in Control Functions should not only have a title and position within the organisation structure commensurate with their responsibilities, but they also need to have the skills needed to effectively challenge the business. This is often difficult for supervisors to assess, but can be done by reviewing meeting minutes as well as meeting with Key Persons in Control Functions, relevant members of the Board (eg Chair of Audit and Risk Committee) and Senior Management.

4.4 Board engagement and reporting

49. “[T]he Board is ultimately responsible for ensuring that the insurer has in place effective systems of risk management and internal controls and functions to address the key risks it faces and for the key legal and regulatory obligations that apply to it”.²⁵ The insurer’s system of internal controls “should be designed and operated to assist the Board and Senior Management in the fulfilment of their respective responsibilities for oversight and management of the insurer”.²⁶

50. “The Board should grant the head of each control function the authority and responsibility to report periodically to it or one of its committees.”²⁷ “In addition to periodic reporting, the head of each control function should have the opportunity to communicate directly and to meet periodically (without the presence of management) with the Chair of any relevant Board committee (eg Audit or Risk Committee) and/or with the Chair of the full Board.”²⁸

51. A challenge cited by supervisors in the survey was difficulty in assessing whether reporting to the Board included the right volume of information, the right level of detail, and whether the information provided the right message about the insurer’s risks.

52. Reporting to the Board should include all key risks, but those risks that are most material should be clearly prioritised. The supervisor should expect the control functions to present realistic risk assessments to the Board and avoid overly positive messages. Relevant information should be provided to the Board by the control function in a timely manner. Key Persons in Control Functions should be given sufficient time to present issues to the Board, with time for discussion and challenge to Senior Management. Reporting should also be actionable with risk metrics being compared to the risk appetite defined in the risk management strategy. Standardised and coordinated reporting can help ensure that the information presented by different control functions is consistent, objective, and forward-looking.

²⁵ ICP 8.0.1

²⁶ ICP 8.2.1

²⁷ ICP 8.3.16

²⁸ ICP 8.3.17

53. Supervisors often rely on the same or similar reporting as that provided by control functions to the Board, making these challenges relevant also for supervisors. This also highlights the difficulty supervisors face if they have to make an assessment based on document review alone. Many supervisors included in their survey response the value of complementing a review of documents prepared by control functions with on-site investigations, including interviews with Key Persons in Control Functions and the non-executive directors with oversight responsibilities. In order to be able to carry out comprehensive analysis, supervisors may seek input from both the control functions presenting their findings and the Board committees receiving these reports.

54. Additionally, in some jurisdictions, the supervisor attends Board meetings and Board committee meetings as an observer. This may help the supervisor assess the way in which the Key Person in Control Function communicates with, reports to, and is regarded by the Board and Board committees. Meeting observations – which can provide evidence on the quality of discussions, challenge, and broader dynamics – can be complemented with interviews with relevant individuals.

5 Internal audit function

55. As stated in ICP 8.7, the supervisor requires the insurer to have an effective internal audit function capable of providing the Board with independent assurance regarding the quality and effectiveness of the insurer's corporate governance framework.

56. ICP 8.7.2 indicates that the internal audit function should provide independent assurance to the Board through general and specific audits, reviews, testing and other techniques²⁹.

57. For the internal audit function, the emphasis is on effective challenge, or the Key Person in Control Function's ability to provide informed critical analysis on risk management policies and processes, and the status to elevate the analysis to the appropriate level within the insurer to effect change. Whether through on-site inspection or other engagements, the supervisor should assess whether the internal audit function has the necessary attributes (stature and independence) to challenge Senior Management to adopt effective controls, including appropriate policies and processes.

58. The following could be indicators of problems related to effectiveness of the internal audit function:

- The insurer uses the internal audit function only for performance or quality assessments and not as a control function that provides independent assurance in respect of the quality and effectiveness of the insurer's corporate governance framework;
- Restricted areas of internal audit universe, including a lack of audit work covering Information Technology and fraud;
- Lack of internal audit findings or/and audit recommendation follow-ups;

²⁹ More details on the responsibilities of the internal audit function are provided in guidance supporting ICP 8.7, in particular ICP 8.7.7 and 8.7.8.

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- Poor scoping and planning of internal audit activities, using inexperienced teams and poor quality reports;
 - Execution of the audit plans not being completed or running very late;
 - Lack of involvement and/or indifference by Senior Management;
 - Limited access to information within the insurer;
 - Internal audit findings and conclusions are consistently positive and support the business unit's goals, plans and strategies; and
 - Audit recommendations do not address root causes.

59. In most cases, these matters can be addressed by the supervisor meeting with the insurer, in particular with the Board. Some jurisdictions intensify their focus on the internal audit function and/or require independent reviews.

5.1 Combination of the internal audit function with second line of defence control functions³⁰

60. ICP 8.7.3 states that, in order to help ensure objectivity, the internal audit function is independent from management and other control functions and is not involved operationally in the business.

61. Survey responses highlighted that the internal audit function should only be combined with other control function in exceptional circumstances, as described below. In these cases, specific safeguards should be implemented to avoid conflicts of interest. In some jurisdictions, a combination of the internal audit function with other control functions and operational functions of the insurer is prohibited, given that an internal audit function should be capable of providing the Board with independent and objective assurance.

62. As part of supervisory consideration in assessing whether combination of the internal function with second line of defence control function is justified and appropriate, supervisors should consider how the insurer will safeguard the independence and objectivity of the internal audit function. Furthermore, the insurer should demonstrate that the effectiveness of the internal audit function would not be compromised with having these functions combined. The insurer should demonstrate to the supervisor that the roles of the combined activities are transparently communicated throughout the entire organisation and explicitly defined within the approved audit charter to avoid any ambiguity regarding the roles of internal audit and the second lines of defence control function.

63. The supervisor should also consider potential disadvantages of prohibiting the combination, for example whether maintaining a person responsible for the internal audit function who does not carry out responsibility for other control functions would incur costs on the insurer that would be disproportionate with respect to the total administrative expenses. However, when considering a combination, the supervisor's decision should be based on proper consideration of both advantages and disadvantages, as well as potential

³⁰ See also Section 6, which is focused on the combination of the second line of defence control functions, also with operational functions and Senior Management functions. Some of the challenges and good supervisory practices described in that section may also be applicable to the combination of the internal audit function with second line of defence control functions.

consequences, including the impact on objectivity and independence of the internal audit function.

64. In particular, the insurer should demonstrate that the internal audit function has a segregation of responsibilities or roles. The segregation of responsibilities should uphold the principle of independence (eg the internal auditor responsible for a particular item in another capacity should refrain from auditing that objective).

5.2 Supervisory use of the work of the internal audit function

65. The majority of survey participants indicated that they use the work performed by the internal audit function as one of the ways to identify and measure risks within the insurer. In some cases, supervisors request the internal audit function to perform specific ad-hoc or bespoke reviews with the scope set by the supervisor.

66. Some supervisors do not rely at all on the work performed by the internal audit function in respect to assessing the performance of the insurer's control environment. Supervisors that do place reliance on the work of the insurer's internal audit function, do so after specifically assessing the effectiveness of the internal audit function. External auditors also can place reliance on internal audit, after having confirmed that the work of the internal audit is suitable. In this context, the supervisor can verify areas of internal audit that overlap with external audit before placing reliance on the work of internal audit.

67. Supervisors that use the work of the internal audit function use the following methods to assess the effectiveness of the internal audit function overall and specifically its ability to provide appropriate assurance on the work performed by other control functions:

- Suitability (competence and integrity) assessments of the Key Person in the internal audit function and in some instances of the Chair the audit committee, or combined audit and risk committee. In some jurisdictions, the head of the internal audit control function is approved by the supervisory authority;
- On-site assessments specifically of the internal audit function or as part of broader supervisory assessments, including regular meetings with the head of the internal audit function;
- Document reviews – notably reviewing reports on audits of the other control functions;
- Review of internal audit plans and, in many cases, the Board audit reports;
- A review of independent third-party assessments of the internal audit function. In some jurisdictions, the internal audit function is subject to periodic required independent reviews and these inform the supervisor of internal audit's effectiveness;
- Interviews with the Chief Audit Executive and the senior audit managers; and
- Requiring the audit committee to review the overall performance and effectiveness of the head of the internal audit function and the function as a whole.

6 Combination of control functions

68. Typically, an insurer has Key Persons in Control Functions and control function staff performing their duties without simultaneously performing the duties of another control function or assuming additional operational or management responsibilities. A decision about

a combining control functions should take into account the risk and size of the insurer. For example, in case of a large insurer with a complex business model, the supervisor may not allow any combination of control functions, whereas in the case of smaller and less complex insurers, it may be appropriate for one function to be carried out by a single person or organisational unit.

69. To appropriately assess the effectiveness and performance of a combined control function, supervisors may find it helpful to make a distinction between three situations:

- A single person simultaneously performs several second line of defence control functions, covered by subsection 6.1;
- A single person simultaneously performs a control function and an operations function, covered by subsection 6.2; and
- A single person simultaneously performs a control function and a Senior Management function, covered by subsection 6.3.

6.1 Combination of second line of defence control functions

70. As noted in ICP 8.3.10: “Notwithstanding the possibility for insurers to combine certain control functions, a control function should be sufficiently independent from Senior Management and from other functions to allow its staff to:

- Serve as a component of the insurer’s checks and balances;
- Provide an objective perspective on strategies, issues, and potential violations related to their areas of responsibility; and
- Implement or oversee the implementation of corrective measures where necessary.”

71. In the case of IAIGs: “The group-wide supervisor requires the IAIG Board to ensure that the group-wide control functions [...] are not combined, unless exceptional circumstances apply...”³¹

72. The majority of supervisory approaches allow combinations of second line of defence control functions in insurers other than IAIGs. When it occurs, where necessary, the supervisor may require that certain conditions be fulfilled, such as:

- There are no conflicts of interest from a functional point of view between the second line of defence control functions performed simultaneously, which implies that the insurer should avoid having the person who is developing a service assess the adequacy of the said service (maker/checker principle);
- The Key Person combining multiple second line of defence control functions possesses the knowledge and expertise needed to perform the responsibilities of the different control functions effectively; and
- The Key Person combining multiple second line of defence control functions has the necessary time and resources needed to perform the responsibilities of the different control functions effectively.

73. A vertical combination of control functions, ie the combination of control functions between the head of the group and an insurance legal entity, may be allowed. This approach

³¹ CF 8.3.c. See also guidance supporting this ComFrame standard.

may be efficient from a resourcing perspective. However, a pure legal entity view may be missing. Allocation of duties, competences and responsibilities to the insurance legal entity may need to be maintained. In this case, supervisors should take into account the underlying circumstances of the combination, such as the:

- Size, scope and nature of the insurance legal entity's business;
- Business model of the group (centralised / decentralised);
- Degree of strategic and operational dependence between the insurance legal entity and the group;
- Insurance legal entity's recovery and resolution plans; and
- Effectiveness of the governance of the insurance legal entity to take decisions in the interests of the safety and soundness of that entity.

The difficulty may be resolved by requiring the clear allocation of duties for both the head of the group and the insurance legal entity, and requiring arrangements that facilitate proper reporting to the Board of the insurance legal entity. In such a situation, the identification and management of conflicts of interests remains crucial.

6.2 Combination of a control function and an operational function

74. Combining operational and control responsibilities should be avoided, as it raises a number of issues related to risk management and conflict of interests. However, this may not be realistic for smaller insurers with more limited resources. When operational and control responsibilities are combined, most supervisors exercise proportionality when assessing the risks from potential conflicts of interest and the insurer's techniques to identify, manage and mitigate these risks.

75. For small and medium size insurers, issues related to the independence of the Key Persons in Control Functions from the operational units represent a challenge. Supervisors find it difficult to require full segregation of functions for these entities but seem to still expect independence, requiring explicit separation of risk management and risk-taking decisions for the same risks.

76. When a Key Person in Control Function is also responsible for carrying out operational tasks or operational functions, it may be easier for supervisors to gain comfort if the operational functions are less risk-generating, like Legal or Human Resources.

77. Where necessary, supervisors may address issues created by the combination of a control function with an operational function by requiring risk mitigation measures, such as:

- Performing an independent review;
- Suggesting modifications in the structure to avoid a situation where work done by one person responsible for an operational function is assessed by the same person, who is at the same time a head of a control function;
- Requiring the establishment of a formal reporting process to the Board in the event of a conflict of interest; and
- Having more regular contact with the control function to assess the operating effectiveness of the control functions.

6.3 Combination of a control function and a Senior Management function

78. In cases where it is justified, the supervisor may allow a combination of a control function and a Senior Management function. When this occurs, the supervisor may require that certain conditions be fulfilled, such as:

- Senior Manager does not combine the role of a Key Person in Control Function and a risk-generating operational function;
- Senior Manager has the necessary time and resources to correctly perform the tasks conferred upon this person as a Key Person in Control Function; and
- Such a combination is accompanied by specific regulations to avoid conflicts of interest (providing in particular for escalation to the Board).

79. Outcomes from the survey indicate the following ways to overcome this issue:

- Imposing dual reporting lines: in this regard, the person combining the two function continues to have a direct reporting line to the Board and be able to escalate directly issues to the Board;
- Specifying limited assignment tasks when dealing with Senior Management responsibility: in this regard, a good practice can be to consider that the person combining a control function with a Senior Management function can only be responsible for the control functions to the extent that these control functions are exercised separately from each other; and
- Specifying that in case of combining the responsibilities of a control function with those of Senior Management, the control function's responsibilities should always be prioritised.

7 Outsourcing of control functions

80. In general, the reasons for outsourcing are cost savings, improving performance and access to skills, expertise and resources that are not available in-house. Another driver of outsourcing are stretched resources caused by the insurer's inability to keep up with growth. Small insurers may not need a full time equivalent for performing their control activities and therefore may consider outsourcing control functions to a third party.

81. There are different supervisory approaches towards the extent of outsourcing control functions. Some supervisors do not allow control functions to be completely outsourced, whereas other supervisors apply the principle of proportionality, including allowing smaller insurers to outsource control functions. For small insurers, for example, it may be sufficient that, instead of maintaining a separate Key Person in Control Function in the insurer outsourcing the control function, a member of executive management of such an insurer has assigned responsibility for control functions and non-executive staff perform control tasks. Some supervisors impose limitations of outsourcing in terms of content and extent (eg only certain operative tasks of the control function may be outsourced).

7.1 Challenges related to supervision of outsourced control functions

82. As stated in ICP 8.8: "The supervisor requires the insurer to retain at least the same degree of oversight of, and accountability for, any outsourced material activity or function (such

as a control function) as applies to non-outsourced activities or functions.” Supervision of outsourced control functions creates a number of challenges, such as:

- Supervision of the process of outsourcing control functions;
- The assessment of the effectiveness of the outsourced control functions, which is one of the main challenges for both prudential and conduct of business supervisors; and
- On-site inspections of control function that have been outsourced to other jurisdictions. These include logistical, resource-related and potential legal challenges.

83. The supervisor should also be mindful of the challenges for the insurer that can be created by outsourcing of control functions:

- Assessment and determination of which control function activities may be outsourced, while ensuring that the overall responsibility for the control function remains with the insurer;
- Identification and mitigation of potential conflict of interests of the third-party service provider (for example, the control function is outsourced to a service provider that also provides other services to the insurer);
- Efficiency of cooperation between the outsourced control function and other control functions, business lines, the Senior Management and the Board;
- Ensuring that the external auditor remains independent if the insurer also outsources its internal audit function to the same provider; and
- A lack of understanding of local circumstances in cases where an insurance legal entity’s control function is outsourced to the group level.

7.2 General good supervisory practices

84. According to ICPs 9.3: “The supervisor reviews outsourced material activities or functions to the same level as non-outsourced material activities or functions.” Challenges, including those listed in the previous subsection, may be addressed by supervisors in a variety of ways, such as those listed below³².

- Supervision of the selection of the service provider:
 - Before entering into an outsourcing arrangement, request the insurer to perform suitability assessments of service providers;
 - Before entering into an outsourcing arrangement, request the insurer to provide a detailed exit plan for a planned or unexpected end to the outsourcing; and
 - Assess whether the insurer’s due diligence process is comprehensive and effective.
- Activities related to the outsourcing contract:
 - Require any outsourcing agreement to give the supervisor the same access to the outsourced provider as to the insurer;

³² The list reflects a number of relevant examples of good supervisory practices provided in the Peer Review of Corporate and Risk-Governance relative to the standards set out in Insurance Core Principles 4, 5, 7 and 8, referenced in footnote 1.

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- Require the insurer to report material outsourcing contracts to the supervisor before inception. This may include a copy of the service level agreement if the supervisor considers it appropriate in order to assess whether the insurer has sufficient oversight rights; and
 - Review the content of the agreements in regard of specific clauses, in addition to checking the existence of an appropriate outsourcing agreement (eg to address the insurer's monitoring and control). In some cases, for example, where control functions are outsourced to a significant extent, supervisors perform a more granular assessment of the outsourcing agreement (eg clause-by-clause review).
 - Supervision of internal arrangements related to ongoing management of the outsourced functions:
 - Review whether the insurer has integrated the outsourced functions into its risk management and the internal control system;
 - Assess whether the outsourced function is included in the scope of internal audit's work;
 - Assess the ongoing supervision by the insurer over the service provider's performance;
 - Interview the service provider to assess how the insurer monitors the service provider's performance; the expertise, knowledge and skills of the service provider; as well as its service capability and financial viability;
 - Assess reporting to Senior Management and the Board covering the outsourced control function and the insurer's oversight of the outsourced control function;
 - Require that the Key Person in Control Function be employed by the insurer and maintain overall responsibility for the outsourced control function;
 - Assess whether a nominated individual of sufficient seniority within the insurer has responsibility for outsourced functions. The responsible person should be suitably qualified and have sufficient time to carry out the role; and
 - Require mitigation measures if the outsourcing of control functions has the potential for creating a conflict of interest or otherwise jeopardising the independence of the control function.
 - Supervision of how risks associated with outsourcing are managed:
 - Assess the risks associated with outsourcing and reflect the results of such an assessment in the supervisor's risk rating of the insurer. In some cases, supervisors compare the risk assessment with the insurer's assessment of relevant aspects of operational risks in the insurer's Own Risk and Solvency Assessment (ORSA);
 - Check whether and how the insurer has carried out a risk analysis when outsourcing;

- Require insurers to maintain a rigorous third party risk management programme;
- Discuss with the Senior Management, the Board and the service provider the ongoing management of the risks associated with the outsourcing arrangement; and
- Request assessment reports by the insurer on the performance of the service provider.

8 Group-wide control functions

85. Most of the challenges described in previous sections of this Application Paper apply to both insurance legal entities and insurance groups. In addition, group-wide supervisors may encounter challenges that are specific to supervision of group-wide control functions.

8.1 Inadequate or inconsistently applied group policies

86. Challenges specific to group-wide supervision include: group policies that are inadequate or applied inconsistently throughout the group; and insufficient time and resources allocated to the group-wide control functions. Supervisors address these challenges in various way, including by:

- Discussing with the Key Persons in Control Functions the group's approach towards coordination of control function responsibilities between the group and business lines, to assess whether there is consistency between policies of all the entities within the group;
- Requesting rationale for specific decisions that may cause supervisory concerns during these conversations;
- Making sure that suitability assessments of group-wide control functions are performed at the level of the group, ie taking into account the broader perimeter of the business model and complexity of the group;
- Reviewing the documented roles and responsibilities of the group-wide control functions, including how the group-wide and insurance legal entities' control functions are meant to interact, how the group-wide control functions, in their own fields, ensure the harmonisation of the group's methods and assess the proper implementation of policies defined at group level, and compare them with observed practices. If inadequate, requiring more comprehensive policies;
- Requiring the group-wide internal audit function to include in its audit plan a specific assessment of individual insurance legal entity's/business line's compliance with group-wide policies; and
- Carrying out on-site inspections and off-site reviews, for example:
 - Organising interviews with Senior Management of the head of the group to assess whether they have sufficient knowledge of the organisational structure of subsidiaries and the relationships between these entities; and

- Obtaining evidence of communication between group-wide control functions and legal entities' control functions and a continuous feedback loop between them.

8.2 Cross-sectoral and international groups

87. Specific challenges may arise from the existence of different types of activities in different parts of the group (ie life and non-life insurance, as well as other financial sector activities, such as banking or asset management). For international groups, jurisdictional differences can create additional challenges, in particular for the group-wide control functions.

88. Groups often enact minimum expectations in group-wide guiding policies and then create bespoke policies and processes in each of the business lines or insurance legal entities. The process of adopting these policies at the insurance legal entity's level can be delayed if the group is slow to provide the insurance legal entity with relevant information on certain business lines. It may also happen that the lines of business in particular insurance legal entities do not fully understand the policies. Group-wide supervisors may address these challenges in the following ways:

- Verify whether there is effective and timely cooperation and information sharing between all the control functions active in different sectors or lines of business of the group; and
- When suspecting issues in this regard, analyse internal audit reports, which may point out these issues.

89. Group-wide control functions of international groups are required to understand businesses in a range of jurisdictions and may need to apply amended policies or practices reflecting different legal or business contexts. Each jurisdiction requires expertise specific to characteristics of a particular jurisdiction, which can be a challenge in terms of human resources. Sometimes the group-wide control functions do not have sufficient oversight of the insurance legal entity's businesses or the insurance legal entity's level control functions are under-resourced or do not have sufficient stature in the context of the group.

90. The supervisor can address these challenges by having conversations with the insurance legal entity's Board and Key Persons in Control Functions to gain assurance about their skill and independence, and discussing these issues with relevant other involved supervisors within supervisory colleges.

8.3 Inadequate communication

91. Inadequate communication between the group-wide control functions and the insurance legal entities' control functions can also pose challenges. In groups with a more centralised corporate governance model, supervisors have seen information filtered as it is communicated from the insurance legal entity to the head of the group, which can take time. In cases of more decentralised governance models, the lack of a central point of responsibility can lead to inefficiencies in the internal control systems if certain areas are not covered by any specific entity in the group. These challenges can be addressed in the following ways:

- Verifying that the tasks and responsibilities of each control function at the entity or group-wide level are clearly established within group-wide policies and internal audit reports and that there is appropriate and effective reporting from insurance legal entities to the head of the group;

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- Verifying that there are effective channels for coordination and regular information exchange between the group-wide control functions and the insurance legal entities' control functions;
 - Verifying that the Key Person in Control Function at the group-wide level has the necessary authority reflected in the insurers' organisational structure and direct access to the Board and Senior Management; and
 - Confirming that the corporate culture within the group allows for transparent reporting of information to the upper level without fear of retaliation.

8.4 Outsourcing of control functions within the group

92. Some supervisors indicated that outsourcing of control functions, if allowed, may pose challenges. A conflict of interest may arise when a Key Person in Control Function at the group-wide level also performs the control function outsourced by the insurance legal entity to the head of the group.

93. Supervisors may take the following actions to address challenges created by outsourcing of control functions within the group:

- Consider which roles for which different insurance legal entities are held by one person when assessing the appropriateness of a Key Person in Control Function (especially their availability to assume all their respective functions, as well as the absence of conflicts of interest);
- Require the head of the group to have a clear view and documentation showing which control functions relate to which insurance legal entity within the group;
- Check that the tasks and responsibilities of control functions are clearly distinguished and justified, in case of accumulation of control functions of an insurance legal entity and the ones of the group;
- Assess whether the insurance legal entity has authority over this Key Person in Control Function as to the functioning of this insurance legal entity;
- In case of outsourcing of a group-wide control function to an insurance legal entity, assess whether the team assigned to the insurance legal entity is performing adequately the coordination tasks belonging to a group-wide control function; and
- Require that outsourcing of control functions within the group (either to the head of the group or another legal entity in the group) or outside the group to be subject to a notification process.