

CEIOPS-CP-08/05  
09 December 2005

## Consultation Paper No. 11

# Draft Recommendation on Independence and Accountability

*CEIOPS welcomes comments from interested parties on the following 'Draft Recommendation on Independence and Accountability.'*

*Due to the increase in Consultation Papers expected in 2006 because of the need to give further detailed advice to the European Commission in the context of the Solvency II project, in relation to this Consultation Paper CEIOPS considers it necessary to shorten the consultation period under its consultation policy to two months.*

*Please send your comments to CEIOPS by email ([Secretariat@ceiops.org](mailto:Secretariat@ceiops.org)) by 09 February 2006, indicating the reference 'CEIOPS-CP-08/05'.*

*CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential.*

## Explanatory text

### Background

1. At the beginning of 2005, the European Commission published a draft of its intended third wave of Calls for Advice<sup>1</sup>. One of these draft Calls for Advice was focussed on the independence and accountability of supervisory authorities in general, and the independence and accountability of the 'Supervisory Review Process' (SRP) in particular. This Call for Advice was, however, not issued to CEIOPS.

As a result of the new solvency regime, also the powers of supervisory authorities will need to be reviewed and adjusted. In particular, an adjustment is needed for those powers concerning the supervisors' ability to effectively control insurance undertakings' risk management and internal control issues, and the possibility for supervisors to require undertakings to hold supplementary capital. Although supervisors already have this latter power under the current regime, this particular area is to become more important in a more risk oriented supervisory system.

It is crucial that all supervisory powers, including any possible new ones, be exercised transparently, within appropriate limits and subject to due process. The appropriate use of powers concerning prudential issues must be complemented by requirements on independence and accountability of the insurance supervisory authorities. *Supervisory action should be foreseeable in order to achieve legal certainty.* Indeed, independence and accountability are closely related to transparency and integrity, as well as linked with one another.

Mindful of the points highlighted above, CEIOPS' Members decided that it was important for CEIOPS to address this important subject even though no formal Call for Advice was issued. It was also decided that the CEIOPS consultation paper on these issues would not take the format used to answer the different Calls for Advice.

2. The following survey is to cover, among others, the following questions:
  - Can the independence of the SRP be taken for granted? What are the minimum prerequisites to be provided within supervisory authorities for such independence?
  - To whom is the supervisory authority accountable? What areas of work are affected? Can/should the supervisory authority be held responsible? If so, to what extent and in which way?

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<sup>1</sup> Draft Specific Calls for Advice from CEIOPS, Consultative Document, Markt/2501/05-EN, Annex 3 to Framework for Consultation.

## Definition of the SRP

3. The purpose of the SRP is to enable the supervisory authority to evaluate, on an ongoing basis, the risk profile, adequacy of financial resources and otherwise prudent conduct (e.g. treatment of policyholders) of insurance undertakings. The primary purpose of supervisory powers is to give the supervisor the ability to achieve its objectives; only by being fully empowered can such goals be achieved. At the same time, it is recognised that power does not come without responsibility, placing demands both on the independence and accountability of the supervisory authority. The SRP should be flexible enough to allow for the prioritisation of future supervisory actions; when necessary, supervisory authorities should have the power to take immediate action to achieve the objectives of regulation, especially to protect policyholders' interests.
4. In its first wave of Calls for Advice, the European Commission in particular draws attention to the IAIS Insurance Core Principles (ICP) and requests CEIOPS to take account of them when preparing its advice and to implement them as soon as possible<sup>2</sup>. The European Commission refers to the IAIS ICP also in its third wave of Calls for Advice.<sup>3</sup> In the following discussion, the terms independence and accountability are looked at separately and correlated to each other *from the basis of IAIS Core Principles*.

## Independence in general

5. The importance of the independence of supervisory authorities is acknowledged by the IMF and the World Bank. Both institutions attach great importance to the independence of supervisory authorities in their 'Financial Sector Assessment Programme' (FSAP), which assesses supervisory authorities on the basis of the IAIS ICP.
6. IAIS ICP 3, 'Supervisory Authority', deals with the independence and accountability of supervisory authorities: "The supervisory authority is operationally independent and accountable in the exercise of its functions and powers". Referring to the authority's independence: "The supervisory authority and its staff are free from undue political, governmental and industry interference in the performance of supervisory responsibilities", and "[T]he supervisory authority is financed in a manner that does not undermine its independence from political, governmental or industry bodies."<sup>4</sup>
7. The IAIS requirements are to be interpreted to the effect that the supervisory authority must be free from undue political, governmental and industry interference as far as ongoing work is concerned. Operational independence is not secured, if, for example the

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<sup>2</sup> See footnote 1, page 9 et seq.

<sup>3</sup> All remarks relating to IAIS Insurance Core Principles made in this paper refer to the Insurance Core Principles of October 2003.

<sup>4</sup> IAIS Insurance Core Principles (October 2003), ICP 3 and Essential Criteria g, h.

supervisory authority is required to report regularly to a superior authority, for example submitting individual supervisory actions for approval, or if prior vetting of the public speeches of the head of a supervisory authority takes place on a routine basis by a superior authority.

## **Regulatory and supervisory independence**

8. The supervisory authority must therefore be empowered and able to make free decisions about the supervision of the undertakings within the remit of its ongoing activities, without other authorities or the industry having the right to intervene or being required to give their consent (e.g. no superior authority with legal powers to give instructions to supervisory authorities in individual cases, which also includes the operational business). Such intervention may either be explicit or implicit, interfering in the normal supervisory activities, thus causing unwanted effects in the market, with negative effects that may affect every stakeholder involved in the insurance activity.
9. A comprehensive analysis of the independence of the supervisory authorities needs to take into consideration the link between supervisory measures and procyclical effects that such measures may have. Experience shows how political interference is more likely to happen under stress situations.
10. Another criterion is clear definition and transparency of the institutional relationships between the supervisory authority and the executive and judiciary. The ICP 3 clearly sets out the circumstances under which the executive is permitted to cross this line.<sup>5</sup> These criteria are necessary to ensure that the scope of authority of the supervisor is clearly defined. Executive and judicial powers should not be permitted unrestricted interference in the work of the supervisory authority. It should be clearly defined where and when such interference is permitted. For this reason, unambiguous rules in respect of the functions (mandate) and the mutual relationships are required.<sup>6</sup>
11. The supervisory authority must operate in a transparent and accountable manner. It needs legal authority to perform its tasks. It should be noted, however, that the possession of authority is not enough to demonstrate observance of a principle. The supervisory authority should exercise its authority in practice. Similarly it is not enough for the supervisory authority to set requirements; it should also ensure that these requirements are complied with. Furthermore, having the necessary resources and capacity is essential for the supervisory authority to effectively implement the requirements.<sup>7</sup>

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<sup>5</sup> ICP 3 Essential Criteria f.

<sup>6</sup> Cf. footnote 7, practise 2.

<sup>7</sup> CEIOPS is aware that, for the time being, there is no harmonisation in Europe on the topic of supervisory powers, in as much as some supervisory authorities lack the power to issue rules, even within their remits, whereas some other authorities enjoy these powers and consider them as necessary to fulfil their mission in a fully efficient and accountable manner. CEIOPS could think about it further in the frame of level 2

12. The legislation should grant sufficient powers for the effective discharge of supervisory responsibilities.
13. This does not mean that supervisory authorities cannot or should not discuss, consult and / or coordinate particular issues with the competent Ministries or with the industry.

### **Institutional independence**

14. Another important point is to define clearly the organisation of the supervisory authority (governance structure). In particular, the existence of internal governance procedures and internal audit are considered important prerequisites for the integrity of supervisory authorities.<sup>8</sup> The authority's structure has to ensure that it is able to meet its tasks and objectives. In the process, an efficient management control system, which identifies the main risks the authority is subject to and implements an appropriate control system, is of central importance.<sup>9</sup>
15. Another important aspect is the existence of procedures regarding the appointment and dismissal of the head and the members of the governing body of the supervisory authority. Institutional independence is given if a superior authority has e.g. no power to dismiss the head of a supervisory authority e.g. by issuing a directive or decree to this effect. When the head of a supervisory authority is removed from office, the reasons are to be publicly disclosed.<sup>10</sup>

### **Financial independence**

16. The financing of the supervisory authority should be designed in a way so as to allow the supervisory authority to fulfil its tasks, duties and objectives, whilst at the same time not permitting politics, government or industry to exert an influence that could erode the independence and competence of the supervisory authority. This means that other authorities or the industry should not be permitted to have undue influence over the decision-making processes in the supervisory authority or on their financial resources. This does not apply to the participation of other authorities and the industry in the administrative councils and advisory bodies of the supervisory authority, and it does not affect the accountability of the supervisory authority to the Parliament and the public.<sup>11</sup>

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and 3, and try to better define what kind of rules should be issued by the supervisor, and what kind of rules should not.

<sup>8</sup> ICP 3 Essential Criteria d.

<sup>9</sup> IMF note on Governance of Financial Sector Oversight Agencies, Second draft, by John Dalton, Udaibir Das, Jennifer Elliot, Ceyla Pazarbasioglu and Marc Quintin, Practise 31.

<sup>10</sup> ICP 3, Essential Criteria e.

<sup>11</sup> See footnote 5.

17. In addition, the supervisory authority has to have discretion to allocate its resources and staff freely in accordance with its mandate.<sup>12</sup> This is necessary so that supervisors can deploy their resources in line with the work load and, should the situation arise, are able to intervene quickly and efficiently.

### **Relevance with regard to the SRP**

18. The SRP addresses the functions of the supervisory authority within the remit of its operational activities. Since the SRP is part of operational supervision, the rules relevant to the independence of the entire supervisory authority are to be applied without restrictions to the sub-section of the SRP, too. If the pan-European rules as expressed in future Solvency II Framework Directive are to comply with the IAIS ICP, the independence of the SRP along the lines set out above will be a prerequisite. A detailed description of this independence is necessary if its significance is to be understood correctly. A general pointer to independence being required is not sufficient.

### **Accountability in general**

19. The IAIS ICP 3 refers to 'accountability' as follows: "The supervisory authority is operationally independent and accountable in the exercise of its functions and powers". ICP 4 states: "The supervisory authority conducts its functions in a transparent and accountable manner." The fact that accountability is mentioned in one sentence together with 'independence' in ICP 3 and stated together with 'transparency' in ICP 4 shows that these terms are closely connected. Accountability cannot be looked at without considering independence and transparency as well, because the accountability and transparency of duties within a supervisory authority are closely connected to its level of independence.
20. According to the ICP, the accountability of the supervisory authority is defined as accountability to the government, the supervised undertakings and the public. The supervisory authority has to inform the parties concerned about its actions and policy and provide the rationale for decisions taken.<sup>13</sup> This requires a combination of concrete rules concerning the supervisor's approaches, disclosure and executive oversight. In addition, the supervisory authority needs to have internal instructions and rules in place for ensuring that it meets its objectives and complies with legislation.<sup>14</sup>
21. The criteria (essential and advanced criteria) for accountability are specified in detail in ICP 4. In general, the supervisory authority has to draw up clear, transparent and consistent supervisory processes and

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<sup>12</sup> ICP 3 Essential criteria i.

<sup>13</sup> ICP 4, Explanatory note No. 4.3.

<sup>14</sup> ICP 4, Explanatory note No. 4.4.

rules.<sup>15</sup> As far as undertakings and the public are concerned, it should be ensured that the decisions of the supervisory authority are subject to judicial review.<sup>16</sup> This, however, applies solely to legal actions in relation to administrative procedures.<sup>17</sup> On the other hand, the process to appeal supervisory decisions should not curtail the supervisory authority's independence or reduce its efficiency.<sup>18</sup> The IAIS does not call for more detailed regulations. These are, after all, not required, since the right to take legal actions offers sufficient protection. As a matter of principle, all regulations and administrative procedures are to be applied to all supervised undertakings equally, though this can clearly be within the context of a risk-based approach to supervision.

22. Accountability and transparency are also interlinked. To provide transparency in respect of its actions, the supervisory authority should make information on its role publicly available and publish a regular report in which the objectives and the substance of its work are described.<sup>19</sup> In this context, the request to the executive of the authority to explain its objectives publicly and describe its performance in pursuing them is to be considered. The supervisory authority is to provide information about its official actions<sup>20</sup> concerning failed undertakings. Furthermore, the supervisory authority should publish information about the general financial situation of the insurance industry.<sup>21</sup> However, accountability and transparency have to be in balance. To avoid losing sight of other interests, e.g. data protection or the interests of the undertaking in distress and its policyholders, for the sake of mere transparency, the extent of transparency should be commensurate with the situation at hand.
23. Accountability means that the supervisory authority is accountable to the Parliament and/or government, the industry and the public, although not to the same extent. The accountability required by the Ministry is different from the accountability towards supervised undertakings or the public. The supervisory authority's accountability to the government is based on the fact that the authority is not permitted to act contrary to existing laws. Its actions must be within the framework of the law, and it must not apply its scope for discretion unduly (Rule of Law). If necessary and requested, the supervisory authority must explain its actions to the Parliament or the Ministry.
24. The accountability to undertakings comprises the entire range of supervisory activities. The authority has to explain its reasons for taking specific measures (e.g. a regular, close and continuous dialogue is required in the process of validation of internal models). At the same time, the undertakings can rely on the consistency of the rules applied.

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<sup>15</sup> ICP 4 Essential criteria a.

<sup>16</sup> ICP 4 Essential criteria c, sentence 1.

<sup>17</sup> See 'Liability of the supervisory authority'.

<sup>18</sup> ICP 4 Essential criteria f.

<sup>19</sup> ICP 4 Essential criteria d + g.

<sup>20</sup> ICP 3 Advanced criteria l + m.

<sup>21</sup> ICP 4 Advanced criteria h.

The supervisory authority must treat all undertakings alike, although according to their individual risk profile, and has to apply its discretion in accordance with the laws. Hence, depending on the circumstances, an ailing undertaking has to come under closer scrutiny than a sound one.

25. The accountability to the public consists in informing the public about the work and objectives of the supervisory authority in the form of public statements, reports, etc. Besides, appropriate and well-balanced information should be provided about the situation of the insurance industry and failed insurers.
26. The right to appeal supervisory decisions applies also to measures taken within the SRP.

### **Liability of the supervisory authority**

27. It is explicitly stated in ICP 4 - essential criteria c (cf. above) - that the administrative decisions of the supervisory authorities have to be subject to judicial review. However, this must not unduly impede the authority's capacity to act. Appeals of supervisory decisions must be possible without independence and efficiency of the supervisory authority being thereby curtailed.<sup>22</sup> This implies that persons affected by an administrative decision have a right to take legal action against this decision.
28. However, the fact that supervisory decisions are subject to judicial review does not imply that all persons concerned may automatically sue for damages. This is made clear for instance in individual national laws, according to which the supervisory authority performs its functions and exercises its powers exclusively in the public interest. This provision is not to be interpreted to the effect that the obligations arising from official duties towards groups of persons or persons who are only indirectly protected by the actions of the supervisory authority (e.g. policyholders) do not have to be accounted for. However, the supervisory authority's general liability arising from erroneous decisions made against directly concerned undertakings and other persons affected by supervisory powers will remain unaffected.
29. As official liability requires a breach of 'an official duty towards a third person', that is a duty towards an individual, third parties are not entitled to claim compensation should a breach of an official duty towards the public on the part of the supervisory authority have occurred. That supervisory authorities have duties towards individuals can be ruled out by national laws. But generally, there should be in place protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties (as also elaborated in ICP 3 and Basel Core Principles). National legislation (or, eventually Solvency II) should provide for this, although CEIOPS is aware that in some Member

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<sup>22</sup> ICP 4 Essential criteria f.

States the national legal system already protects persons or organisations who deserve protection (if reasonably acted) and therefore a legal protection from liability for supervisory actions in good faith is not necessary.

30. What this means for the supervisory authorities and with regard to the decisions made under the future SRP, is that supervisory authorities may be sued for damages in relation to erroneous supervisory actions taken directly against undertakings or persons, if the future Framework Directive or – failing that - the national law decrees this. Official liability would pose a significant risk for supervisory authorities as by their nature supervisory actions can have a considerable financial impact on undertakings or affect the financial interests of a large number of people with the outcome of possible lawsuits mostly uncertain. It is only reasonable to expect that facing this risk would influence the decision-taking process of a supervisory authority and make it less prepared to take action where this could result in getting sued for a high amount of damages.
31. The conclusion drawn from this with regard to the SRP within the framework of Solvency II is that those directly concerned must have a right to appeal the decisions or acts of public administration.

#### **CEIOPS' Advice**

32. In its ongoing operational activity the supervisory authority must be free from undue political, governmental and industry interference.
33. The financing of the supervisory authority should be designed in such a way as not to permit any undue interference by politicians, government or industry, and as to enable effective supervision.
34. The supervisory authority must have appropriate internal governance procedures, including internal audit arrangements, in place.
35. The institutional relationships between the supervisory authority and the executive and the judicial are to be transparent and clearly defined.
36. The supervisory authority should have discretion to freely allocate its resources and staff so that it can act appropriately in accordance with its mandate and fulfil its objectives.
37. There must be transparent procedures regarding the appointment and dismissal of the head and the members of the governing body of the supervisory authority. When the head of a supervisory authority is removed from office, the reasons are to be publicly disclosed.
38. The supervisory authority must operate in a transparent and accountable manner. The supervisory authority must also in practice exercise its authority itself.
39. The supervisory authority must perform its functions within the

framework of the law; it must not apply its scope for discretion unduly (Rule of Law).

40. The supervisory authority has to adopt clear, transparent and consistent supervisory processes and rules.
41. The administrative decisions of the supervisory authority must be subject to judicial review. Those directly concerned should have the right to appeal against these decisions.
42. This approach will be applied to all supervised undertakings equally, though this can clearly be within the context of a risk-based approach to supervision.
43. The supervisory authority discloses its objectives and the essence of its functions and activities to the public.
44. Legal protection to the supervisory authorities and their officers against lawsuits for action taken in good faith while discharging their duties must be provided.