CLIFFORD CHANCE

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Strengthening accountability: SIMR and the PRA's focus on Governance

On 7 March 2016, the Senior Insurance Managers Regime ("**SIMR**") came into effect. Although based on Solvency II governance requirements, the SIMR is a significant extension from these requirements. This extension, coupled with the PRA's increasing focus on Board Governance, demonstrates a renewed drive to 'strengthen accountability'.

Overview

This note sets out certain key issues arising from the implementation of SIMR and also takes a closer look at two key PRA publications on the subject:

- Supervisory Statement SS5/16 Corporate governance: Board responsibilities, published on 31 March 2016, and
- The PRA's approach to insurance supervision, published 11 March 2016.

We also look at HM Treasury's future proposals in respect of the Senior Managers and Certification Regime and expected changes to the SIMR.

SIMR

Key Function Holders

The SIMR regulatory process was initiated by a letter from Sam Woods, the PRA's Executive Director of Insurance Supervision, on 25 August 2015. The letter asked insurers to identify individuals performing 'certain functions' and either:

- grandfather (or transfer) those individuals approved under the PRA and FCA's Approved Persons Regime to an SIMR equivalent function and submit the necessary materials (including a Grandfathering notification Form K) by 8 February 2016 latest; or
- make a new application for approval of the individual after 1 January 2016

Although the deadlines were clear, the concept of 'Key Function Holders' – a term derived from the Solvency II Directive – was not. The letter confirmed that *'these are functions whose operation, if not properly managed and overseen, could potentially lead to significant losses being incurred or to a failure in the ongoing ability of the firm to meet its obligations to policyholders'*. However, this guidance did not stem from Solvency II, instead it is a narrative produced by the PRA on the basis on its FSMA objectives.

The PRA made clear that firms needed to identify 'other Key Functions' in addition to those mentioned in the Solvency II Directive's definition of 'function' , namely the risk management, compliance, internal audit, and actuarial. The PRA also included a list of examples of other possible functions in SS35/15 Strengthen individual accountability in insurance, although the PRA made it clear that the list was 'non exhaustive'.

Leaving it to firms to determine their own 'Key Functions' has lead to an uneven application of the SIMR. Some issues were addressed and dealt with in the PRA's SIMR Q&A, however many go answered. For example, the PRA has not addressed the appropriate treatment of certain other functions, including legal (although for most insurers, this would be included as part of the compliance function). Neither has the PRA (nor the FCA) given any indication as to which 'Key Function' should have oversight of core responsibilities, such as Conduct Risk, the mismanagement of which can have prudential, as well as conduct, implications.

Key Function Performers

Through the application of its Conduct Standards, the PRA created a new sub-set of individuals, 'Key Function Performers', on which it places high level requirements. Specifically, any person performing a key function is required to observe the first three Conduct Standards.

This is significant because the PRA did not make it explicitly clear in its

SIMR consultation that it had intended to cast the net of accountability so widely. This also has implications for firms – compliance manuals and policy documentation will need to be amended to make clear this requirement for, potentially, a large number of employees.

SIMF 7

A person in a group role will be a Group Entity Senior Insurance Manager (SIMF 7) if (a) they have *'a significant influence on the management or conduct of one or more aspects of the affairs of the [UK firm's regulated activities'* and (b) they are not performing another SIMF.

'Significant influence' is not defined by the PRA, but the PRA's expectation is that the SIMF 7 function will only apply to group persons who meet the criteria in section 59ZA of FSMA ('test one') and are in a 'Key Function' ('test two').

Test one essentially requires the individual to be taking decisions or participating in decision-making (alone or collectively) about aspects of the UK firm's regulated activities which might involve a risk of serious consequences for the firm or its business.

Test two requires the individual to be performing a Key Function, the most relevant of which for individuals in group roles is that they are '*effectively running the firm*' or otherwise '*performing a function that is of specific importance to the sound and prudent management of the firm*'.

In this regard, the PRA has stated that the SIMF 7 function should '*include any individual within the group (e.g. a Group CEO) whose decisions and actions [are] regularly taken into account by the board of the UK firm*', but that it does not expect people in group roles who simply set the group's overall strategy, but are not responsible for implementation at the UK level, to be an SIMF 7.

In practice, there appears to be a subjective and, therefore, potentially inconsistent approach when approving SIMF 7 applications. The PRA has required registration of SIMF 7 individuals even where there does not appear to be the required level of "significant influence". In any case, it may be that the PRA moves away from its adopted stringent approach once it becomes comfortable with the operation of the SIMR.

Corporate governance

SS5/16 does not intend to provide a comprehensive list of what constitutes good or effective governance, for which purpose the UK Corporate Governance Code is more relevant. It does highlight the PRA's expectations on boards and will be integral to any section 166 review assessing a firm's 'Governance, Control and Risk Management Framework'.

However, the significance of SS5/16 cannot be understated. It is the first time a regulator has imposed supervisory expectations in addition to the UK Corporate Governance Code and the first occasion that the PRA has clearly flagged the collective responsibilities of a board, which are 'additional and complementary' to the prescribed responsibilities under SIMR.

There is also significance in the introductory wording, where the PRA effectively sub delegates its FSMA objectives by *'requiring boards and management of regulated firms to run the business prudently, consistent with the firm's own safety and soundness and the continuing stability of the financial system*'.

These high expectations may prompt board members to ask what the overriding objective of an insurer is - is it to provide benefits to the insured in accordance with the contracts concluded with them? Or satisfy its shareholders? Or to act prudently with the 'continuing stability of the financial system' in mind? With the implementation of Solvency II, a strong prudential regulatory regime will be at the forefront of the governance framework for insurers, however, the first two questions will impact on setting the 'right' culture at the firm which, as the PRA point out, is for the board to embed and maintain.

SS5/16 flags the importance of 'robust and well-targeted management information' and this information will be essential for NEDs to hold the Executive to account. Although the PRA's expectation is clear, in practice, there may be differences between what the regulator wants MI to focus on and that which the board may feel is most relevant. This may be due, in part, to the vast amount of information which insurers have access to, which may or may not be relevant – and the relevance is often dependent on what the regulators' (and/or boards) focus is at any given time.

SS5/16 sets out expectations of good governance on PRA regulated subsidiary boards. However, the statement is notably silent in respect of expectations on a group board especially given their potential to impact the board dynamics of a UK regulated entity – the lack of PRA guidance on this issue is noteworthy given their approach to SIMF 7 allocation. In any case, the board will likely need to provide for independent review and appropriate challenge, including in respect of input from its parent undertakings.

SS5/16 does, however, recognise the potential for conflicts of interest between the firm and the wider group, especially where there are cross directorships. To reduce the risks associated with such conflicts, firms should consider specially how to deal with conflicts and/or confidential issues in the board's terms of reference ("**ToR**"), but also in the Risk Management Committee's ToR.

Key governance considerations…

Risk appetite

- Is the firm's business strategy supported by a well-articulated and measurable statement of risk appetite?
- Can the firm show evidence of the active and effective oversight of risks, risk management and risk control appropriate to its risk appetite?
- How does the firm evidence that the discussions and decisions of the board and its relevant sub-committees are supported by meaningful and well-targeted management information?

Setting strategy

- Is the firm able to demonstrate to the PRA that the board has established a sustainable business model and corporate strategy? and that it takes decisions in accordance with a clear and prudent strategy and risk appetite?

Culture

- Does the board articulate and maintain a culture of risk awareness and ethical behavior?
- Does the board articulate and embed the firm's culture across the entire organisation when pursuing its business goals?
- Do non-executive directors ("**NEDs**") hold management to account for embedding and maintaining culture?

Board composition

- Is there a sufficient number and quality of independent NEDs?
- Do the NEDs have a sufficient breath of understanding of the business to provide effective challenge to the executives if necessary?

Management information ("MI") and transparency

- Is the board provided with timely, accurate, complete and relevant MI?
- Do the chairman and NEDs manage the nature, the specific content and the frequency of MI provided to the board?
- Does management openly and transparently communicate with the board?
- How does the firm ensure that the board is adequately informed of significant matters, including key business developments, decisions and activities?
- Are there processes in place which allow for an issue to be disclosed or escalated to the board?

PRA's approach document

Following the implementation of Solvency II and the SIMR, the PRA issued an updated Insurance approach document. The main changes to the document are summarised in its annex at page 75.

Key changes are made in respect of the PRA's risk framework – this is used by the PRA to assess and make judgements in respect of the risks an insurer is exposed to. The framework incorporates three key elements:

- the potential impact that an insurer could have on financial stability and policyholders, both by the way it carries on its business and in the event of failure;
- how the external context in which an insurer operates and the business risks it faces (together, its risk context) might affect the viability of the firm; and
- mitigating factors, covering: an insurer’s management and governance and its risk management and controls

(operational mitigation); its financial strength, specifically capital and liquidity (financial mitigation); and its resolvability (structural mitigation).

It is the latter point that is of particular importance in the context of this briefing. The PRA has flagged an insurer's management and governance as a key mitigant to risks posed to the PRA's objectives. This shows that the PRA has incorporated into its supervisory framework its policy objective of accountability and good governance.

The PRA has also updated its approach to 'Management and Governance' at page 39 of the document. Here, the PRA sets out the layering of its 'fit and proper' requirements, so that an individual only has the required fitness and propriety when they comply with 'all relevant rules' (including SIMR rules) but also act in line with the PRA's Threshold Conditions, the Fundamental Rules and any conduct standards or conduct rules applicable to them. This is in addition to acting in line with the PRA's expectations as set out in various supervisory statements and the approach document itself.

This layering approach reinforces the view that being a director of a PRA regulated firm has become progressively more demanding and involves higher standards of behaviour and tougher fit and proper standards. The PRA can also use a firm's governance map to pinpoint the allocation of responsibilities, which are further enforced by the prescribed responsibilities allocated to senior individuals.

Key governance considerations continued…

Roles of executive directors and NEDs

- Do all board members, regardless of their specific duties as executive or NEDs, share in the wider board duty to promote the success of the company and to ensure the regulated firm continues to meet the Threshold Conditions under the Financial Services and Markets Act 2000?
- In particular, are the NEDs and the Chairman challenging executive management and holding them to account effectively?

Knowledge and experience of NEDs

- Do the NEDs have sufficient current and relevant knowledge and experience to understand the key activities and risks involved in the business model?
- Is the firm able to demonstrate the effective challenge of NEDs, particularly in relation to key strategic decisions?
- Do the NEDs take responsibility for major decisions? Or do they simply delegate to individuals who are considered specialist in the area?

Succession planning

- Are there robust succession plans which recognise current and future business needs?
- Do these plans address the unexpected loss of key individuals, particularly those covered by the SIMR?

Remuneration

- Does the board oversee the design and operation of the firm’s remuneration system?
- How does the board ensure that any incentives are aligned with prudent risk taking?

Subsidiary boards

- Are any subsidiary boards alert to potential for conflicts of interest? Are they able to take decisions independently where required?
- How many key positions on the subsidiary board are occupied by executive members of the group or parent company board? *The PRA considers it generally undesirable for some key positions on the subsidiary board to be occupied by executive members of the group or parent board, such as chairman, chair of the key sub-committees, chief executive or finance director. This does not prevent group NEDs from chairing or sitting on the subsidiary board as NEDs.*

Board committees

- Are sub-committees able to support the board? Are they accountable to it?
- Do any sub-committees relieve the board of any of its responsibilities?

The 'Culture and behaviour' section at page 40 has also been updated. It reiterates the messaging in SS5/16, principally, that there is *'no right culture*' that the PRA has in mind when it assesses a firm but an insurer should have *'a culture that supports prudent management'*. In any case, it is for the board to invoke change or embed the culture of the firm, reinforcing the 'tone from the top'. It is, therefore, important for firms to consider how they can assess whether the right messaging is filtering down, especially in respect of customer facing staff.

The changes to the insurance approach document reinforce the PRA's commitment to assessing board effectiveness. Therefore, firms should, in the light of SIMR, stress-test their governance including assessing their board and committee effectiveness because, when done properly, such reviews can provide effective long-term solutions to issues relating to time, resource, and risk management.

Future developments

On 15 October 2015, HM Treasury published a policy paper (note not a consultation, therefore the determined policy is only being made public) which detailed measures in the Bank of England and Financial Services Bill (the **"Bill")** to extend and reform the Senior Managers and Certification Regime ("**SM&CR**") to all FSMA authorised persons.

The paper makes clear that the SIMR *'already incorporate some of the substantive ideas and principles underpinning the SM&CR'*. For example, through the allocation prescribed responsibilities and by requiring a governance map. Since these requirements are already in place, HM Treasury are of the view that the SIMR will pave the way for the application of the SM&CR to insurers.

However, below are features of the proposed SM&CR which are not currently features of SIMR:

- a statutory requirement for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility;
- a requirement on firms to certify as 'fit and proper' any individual who performs a function that could cause significant harm to the firm or its customers, both on recruitment and annually thereafter; and
- a power for the regulators to apply enforceable rules of conduct to any individual who can impact their respective statutory objectives.

The Bill has now received Royal Assent and it is anticipated that the PRA will consult on the proposed new regime later in the year. Insurers should be prepared for further compliance reviews and associated costs. For further details on the SM&CR, please refer to our briefing New rules for senior executives in insurers, investment firms, asset managers, brokers and consumer credit firms - May 2016.

How we can help…

- We have experience in reviewing and updating compliance manuals and firm polices, including board terms of reference documents, to ensure SIMR compliance.
- We have advised on governance maps and SIMR Controlled Functions allocations, including assisting with SIMF 7 and Key Function identification.
- We can advise and undertake governance and board effectiveness reviews to ensure that firms and their boards are in compliance with PRA requirements.
- We can assist in all other aspects of SIMR and SM&CR implementation.

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