HERBERT SMITH FREEHILLS

KEY GOVERNANCE DEVELOPMENTS

"AT A GLANCE" GUIDE FOR INSURERS

Following the introduction of the **Senior Insurance Managers Regime** last year and **PRA Supervisory Statement SS5/16 on Board Responsibilities**, the governance landscape for insurers continues to develop. The **Audit Directive**, which applies to financial years beginning on or after 17 June 2016 (subject to transitional provisions), will affect the way in which insurers manage their audit (including audit committee) arrangements, and in particular introduces independence requirements to most firms. The **extension of the banking sector Senior Managers and Certification Regime** ("**SMCR**") to all authorised firms will also bring change to insurers' compliance and governance processes. A consultation paper on the extension of the SMCR is expected in O2 2017.

AUDIT DIRECTIVE AND REGULATION

- The Audit Directive and Audit Regulation made a number of changes to the audit regime for public-interest entities ("**PIEs**"), including
  - mandatory rotation of auditors
  - restriction of non-audit services
  - mandated audit committee and duties
- PIEs include banks and **insurance companies**
- How the rules apply to an insurer depends on whether the PRA regards it as "**significant**" or "**low impact**"
- Implemented in the UK by the Audit Committee Part of the PRA Rulebook
- An insurer is "significant" if it has been assigned to **category 1 or category 2 of the PRA's categories of "impact"**, as discussed in the PRA's "Approach to Insurance Supervision", March 2016
- Changes apply to financial years beginning on or after **17 June 2016, subject to transitional provisions**

REQUIREMENT FOR AN AUDIT COMMITTEE

- Applies to all **Solvency II firms, the Society of Lloyd's** and **Lloyd's managing agents**
- **Possible exemption for smaller insurers (including small mutual insurers)** if:
  - the board is performing equivalent functions;
  - minimum requirements of the Audit Directive are met; and
  - criteria for granting a waiver under s138A FSMA are met
- **Exemption for a subsidiary of an EEA parent** that itself complies with audit committee requirements (see further discussion below):
  - where the subsidiary has been categorised as "significant" by the PRA, if all of the NEDs on its board are the same as those on the parent's board; or
  - where the subsidiary has been categorised as "low impact" by the PRA
- A **transitional period of two years** will apply for firms to implement the changes (see final column of the table opposite for summary of transitional provisions)

SUMMARY OF AUDIT DIRECTIVE REQUIREMENTS FOR AN AUDIT COMMITTEE*

Type of firm	Requirement for Audit Committee ("AC")?	Membership (in addition to requirement for all members to be NEDs)	Transitional provision (financial years commencing before 17 June 2018)
Low impact firm (not a subsidiary)	Yes	Majority, including chairman, to be independent NEDs ("**INEDs**")	Board may perform equivalent functions to AC No membership requirements apply
Significant firm (not a subsidiary)	Yes	All INEDs	Must have AC consisting of a majority of INEDs, including the chairman
Low impact firm (EEA parent)	No, provided parent complies with Directive requirements	If AC is required, majority, including chairman, to be INEDs	Board may perform equivalent functions to AC No membership requirements apply
Significant firm (EEA parent)	No, provided: (a) parent complies with Directive requirements; and (b) subsidiary board NEDs are the same as parent board NEDs	If AC is required, majority, including chairman, to be INEDs, provided all members of parent AC are independent If not, all INEDs	No requirement for AC provided parent complies with Directive requirements If AC is required, majority, including chairman to be INEDs
Low impact firm (non-EEA parent)	Yes	Majority, including chairman, to be INEDs	Board may perform equivalent functions to AC No membership requirements apply
Significant firm (non-EEA parent)	Yes	Majority, including chairman, to be INEDs, provided all members of parent AC are independent If not, all INEDs	Board may perform equivalent functions to AC No membership requirements apply

* **This table reflects the UK implementation of the requirements but does not take account of waivers that may be given by the PRA to smaller firms (see opposite).**

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AUDIT COMMITTEE COMPOSITION

- A committee of the board, comprising only NEDs
- Chair to be independent and appointed by committee members
- Independence of membership requirements apply (see next column for meaning of "independent")
- At least one committee member must have competence in accounting or auditing

EXEMPTION FOR SUBSIDIARY OF EEA PARENT

- Exemption for subsidiaries of EEA parents only applies if the EEA parent "complies at group level with Chapter 2 [of the Audit Committee Part of the PRA Rulebook]" (Rule 1.2, Chapter 2)
- As Chapter 2 only applies to "firms" i.e. PRA-authorised firms, it is not clear what this means for the EEA parent
- In particular, does the parent have to meet requirements applying to a "significant" firm or a "low impact" firm?
- Safest course must be for the parent to apply the same rules as would otherwise apply to its subsidiary i.e. the parent of a "significant" subsidiary must satisfy the more onerous requirements applying to "significant" firms
- Non-UK EEA parents of a UK subsidiary may be subject to less onerous rules provided that they comply with Article 39 of the Audit Directive

OTHER KEY POINTS ON AUDIT COMMITTEES

- Chair of the audit committee requires pre-approval under the Senior Insurance Management Function (SIMF 11) and has responsibility for overseeing performance of audit committee
- PRA SS5/16 states that the chair of the audit committee is deemed to be responsible for safeguarding the independence and overseeing the performance of audit function, including the head of internal audit
- Board as a whole needs to apprise itself of audit issues – SS5/16 is clear that a board's committees do not relieve the board of any of its responsibilities

PRA SS5/16: A RECAP

General

- Guidance for PRA-authorised firms, including insurers
- Largely a restatement of existing governance good practice
- Board needs mix of skills and experience to make informed decisions and oversee risk effectively
- PRA expects to see evidence of establishment of effective business model, clear and prudent strategy, effective risk management processes and for the board to hold management to account in implementing these
- Board responsible for embedding culture of risk awareness and ethical behaviour

Independence

- Focus on role of NEDs in holding management to account and the importance of their independence in order to safeguard customer interests and firm's regulatory obligations
- PRA expects to see effective challenge of strategy
- Board should have significant number and quality of NEDs who are independent and have sufficient breadth of experience to provide effective challenge. For listed firms, at least half the board should be INEDs. For smaller firms, at least two INEDs should be on the board
- Chairman should be independent on appointment
- PRA put forward certain independence criteria, mirroring paragraph B.1.1. of the FRC UK Corporate Governance Code, in CP34/15. PRA has confirmed that not all factors need to be "passed" for a NED to be judged independent. It is for the board to determine whether a director is independent

Subsidiaries

- Subsidiary boards must be capable of acting in the best interest and safeguarding the safety and soundness of the firm for which they are responsible
- The same need for effective independent presence across the board and other principles of good governance therefore applies to subsidiaries
- The key is that the subsidiary is able to take decisions independently where required to meet its own regulatory obligations – the PRA sees board independence as a way to ensure this

SMCR

- Extension of SMCR to insurers is likely to result in changes to insurers' systems and procedures
- Consultation paper expected Q2 2017
- Likely that FCA will engage with firms on points of detail prior to release
- Unclear what the full shape of the regime will be at present but key points of difference likely to be
    - **Certification regime** – which functions will need to be certified?
    - **Fitness and propriety and conduct rule compliance** – processes to implement procedures for a much wider population of certified staff
    - **Duty to take reasonable steps** – practical implications for Senior Managers regarding compliance and record keeping
    - **Solvency II** – how the regime will be adapted (if at all) to take account of Solvency II governance requirements e.g. will some key function holders become Senior Managers?

NON-FINANCIAL REPORTING

The EU Non-Financial Reporting Directive (EU/2014/95) requires EU-incorporated large PIEs, to disclose in their annual report information about policies, risks and outcomes as regards environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters (an "NFI Statement"). Large PIEs include insurers with more than 500 employees, and PIEs which are the parent undertaking of a large group with more than 500 group employees. UK implementation has been effected by amendments to the strategic reporting requirements in the Companies Act 2006. The changes took effect for financial years beginning on or after 1 January 2017.

CONTACTS

Geoffrey Maddock
Partner
T: 020 7466 2067
geoffrey.maddock@hsf.com

Barnaby Hinnigan
Partner
T: 020 7466 2816
barnaby.hinnigan@hsf.com

Alison Matthews
Consultant
T: 020 7466 2765
alison.matthews@hsf.com

Matthew Brewer
Senior Associate
T: 020 7466 2382
matthew.brewer@hsf.com