MALTA FINANCIAL SERVICES AUTHORITY

THE NATURE AND ART OF FINANCIAL SUPERVISION

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Contents

Table of Abbreviations

AML/CFT	Anti-Money Laundering / Combating the Financing of Terrorism
CS	Conduct Supervision Function
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ESAs	European Supervisory Authorities
EU	European Union
FCA	Financial Conduct Authority
IPS	Insurance and Pensions Supervision Function
MFSA	Malta Financial Services Authority
MLRO	Money Laundering Reporting Officer
MOUs	Memoranda of Understanding
NCAs/NSAs	National Competent Authorities / National Supervisory Authorities
ORSA	Own Risk and Solvency Assessment
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
SRP	Supervisory Review Process
TSI	Technical Support Instrument
UK	United Kingdom
IRRD	Insurance Recovery and Resolution Directive

Introduction

The purpose of this publication is to illustrate the Malta Financial Services Authority (MFSA)'s approach to the supervision and oversight of insurance and reinsurance undertakings as well as insurance intermediaries whose head office is in Malta. This publication also aims at illustrating work conducted by the Insurance and Pensions Supervision Function (IPS) as part of the Supervisory Review Process (SRP). This document provides an overview of numerous core areas which the Authority has been focusing on during the past year in relation to:

- the supervision of insurance and reinsurance undertakings and insurance intermediaries;[1]
- a number of common recurring weaknesses and shortcomings that have been identified by the Authority during the course of desk-based reviews and on-site inspections; and,
- the Authority's expectations which undertakings and intermediaries are required to meet at all times.

This document also outlines the Authority's supervisory priorities in relation to insurance and reinsurance undertakings and insurance intermediaries as per the MFSA's Supervisory Priorities 2023.[2]

[1] This circular does not cover supervisory work carried out in relation to pensions
[2] https://www.mfsa.mt/wp-content/uploads/2023/03/MFSA-Supervision-Priorities-2023.pdf

1. Supervision of (Re)Insurance Undertakings and Insurance Intermediaries

1.1 Background

The Insurance and Pensions Supervision and the Conduct Supervision Functions within the Authority are responsible for the supervision of (re)insurance undertakings and insurance intermediaries (herein referred to as "entity" or collectively as "entities") from the prudential and conduct aspects, respectively. The prudential aspect deals with the entities' financial and organisational robustness whereas the conduct aspect relates to ensuring that the entities concerned act honestly, fairly and in accordance with the best interest of their clients. Accordingly, in the course of its supervisory activity, the Authority engages with various entities to ensure that they meet both their prudential and conduct requirements on an ongoing basis. This is done primarily through both on-site and off-site supervision, which also includes the carrying out of thematic reviews by the Authority.

Whilst the ongoing desk-based supervision remains a key tool for the Authority to ensure that entities are compliant with the regulatory requirements which apply to them, the Authority has continued to strengthen its resources to increase its engagement with licence holders through on-site inspections and supervisory meetings; broaden the collective skills and knowledge of the team; as well as, integrate financial crime compliance into its supervisory work to ensure that AML/CFT focus is embedded in the supervision of undertakings and intermediaries. The Authority has also increased awareness on sustainable finance amongst the entities it supervises in order to build the necessary knowledge, not just to ensure compliance with the requirements being imposed by EU regulations, but also to drive ambitious policies to the benefit of policyholders. These initiatives have further enhanced the quality and effectiveness of the supervision carried out.

The continuous development and enhancement of the Authority's risk-based approach to supervision, coupled with the strengthening of its resources has resulted in improved regulatory outcome in the past years.

1.2 The Supervisory Review Process ("SRP")

The SRP refers to all activities conducted by the Authority in order to comply with the obligations emanating from Article 31B of the Insurance Business Act (Chapter 403 of the Laws of Malta) which *inter alia* transposes Article 36 of Directive 2009/138/EC ('the Solvency II Directive'). This includes the evaluation of strategies, processes and reporting procedures established by undertakings to comply with insurance legislation. Whilst the Authority applies the principle of proportionality throughout all stages of the SRP, it also ensures that the SRP is applied in a consistent manner across all undertakings. Inevitably supervisory judgement is to be used at each stage of the SRP. The Authority reaches judgement on the risks that an undertaking is running and how to address any problems or shortcomings identified. In particular, the Authority decides which risks are the most material and require supervisory intervention.

Through a combination of off-site and on-site supervision the Authority reviews and evaluates the strategies, processes and reporting procedures established by undertakings. The Authority uses a number of different supervisory tools to implement its supervisory work. It deploys its resources on a proportionate basis, taking into account the risk profile and systemic importance of undertakings. The Authority considers that the risks faced by undertakings or to which they can be potentially exposed are influenced by six main risk drivers, namely:

i. the quality of an entity's governance, its systems, operations and internal controls;
ii. the financial soundness of the entity;
iii. the quality of the entity's assets;
iv. the macro-economic risks it is exposed to;
v. the undertaking's business model; and,
vi. the manner in which the undertaking conducts its business, i.e. the extent to which it ensures that it acts honestly, fairly, and professionally, as well as in the best interest of its clients.

The analysis of these risk drivers in addition to the ORSA report submitted by undertakings, assist the Authority in obtaining a picture of the future risks that an undertaking may possibly be exposed to and the effects that such risks may have on the undertaking's strategy, business model and capital requirements.

The Authority also conducts its supervisory activities in a proportionate manner, commensurate to the nature, scale, and complexity of the risks inherent in the business of undertakings. This includes adopting adequate supervisory process to ensure effective and timely communication and engagement with other supervisors.

To ensure that adequate resources are allocated to undertakings that require most attention, the Authority utilises the outcome of its internal Risk Assessment Framework, and other supervisory information to develop the supervisory workplan.

The prudential supervisory workplan provides a framework for the supervisory work to be carried out including the frequency and intensity of such work depending on the risk posed by each undertaking. The said risk is determined by an overall score which is derived from a combination of quantitative and qualitative data. The assessment of risks includes two dimensions:

1. *the level of impact* – This is classified into four categories - Low, Medium Low, Medium High and High. This assessment reflects the potential impact that the failure of a particular undertaking would have on its policyholders and on the financial system.

2. *probability (i.e. the likelihood of occurrence)* – This is also classified into four categories - Low, Medium Low, Medium High and High. This assessment evaluates the likelihood that a particular undertaking fails. The following elements are considered when carrying out a probability classification - analysis/assessment of risks, analysis/assessment of risk controls, analysis of risk drivers and analysis of relevant risks to the insurance sector.

In addition, during 2023 Conduct Supervision ('CS') have developed a Conduct Risk Model which measures the entities risk from a conduct perspective.

The combination of the above assists the Authority in prioritising its on-site and off-site supervisory tasks and activities and direct its supervisory resources to undertakings that present the greatest potential risk to policyholders and financial stability. Through this process, the Authority is also able to identify the areas of focus of on-site visits which also includes AML/CFT checks to ensure more effective supervisory outcomes.

1.3 International Cooperation

The MFSA reports to the European Insurance and Occupational Pensions Authority ('EIOPA') which is one of the three European Supervisory Authorities ('ESAs'), and which also acts as an advisory body to the European Commission, the European Parliament and the Council of the European Union ('EU'). Through its regular and active participation in EIOPA Committees, the MFSA, together with other National Competent Authorities ('NCAs'), contributes to shape informed policies and laws at EU and national levels.

The Authority also participates in various other working groups and task forces set up to discuss and evaluate specific areas of insurance regulation.

The MFSA has signed a number of bilateral Memoranda of Understanding ('MOUs') to ensure the effective supervision of licence holders, facilitate the exchange of information and create a formal framework for regulatory collaboration and co-operation between various regulatory authorities. These MOUs provide for clearer channels for co-operation including increased mutual co-operation, the exchange of regulatory and technical information as well as investigative assistance between the signatories of the said MOUs. The MFSA has also signed a number of Multilateral MOUs with institutions such as EIOPA and the International Association of Insurance Supervisors.

In the past years, the Authority has further improved its relationship and engagement with the NCAs of other Member States, sharing information on a bilateral basis, experiences, and issues, particularly in relation to cross border business. This initiative enabled the Authority to gather a better understanding of the underlying risks where undertakings are operating via freedom of services or freedom of establishment in other EU and EEA Member States.

The Authority has also been organising college meetings for the insurance groups which it supervises, as group supervisor, in terms of the Solvency II Directive. These are meetings which are attended by representatives from NCAs of other Member States as well as a representative of EIOPA. Furthermore, the Authority also actively participates in several group colleges, where it is a member and in other specific EIOPA co-operation platforms.

1.4 Developments in the Regulatory Framework

The following are the major developments during 2023 relating to the insurance sector:

- On 16 January 2023, IPS issued a Circular on the Supervisory Statement on Inflation issued by EIOPA on 22 December 2022. In this Circular, the MFSA highlighted that the Supervisory Statement addresses the main impacts of inflation on insurance and reinsurance undertakings, which may affect both life and non-life business. It was also noted that the Supervisory Statement also aims to support the end of year Solvency II calculations, raising awareness about the relevant Solvency II provisions, and aims to foster convergence and consistent supervisory approaches across Member States;

- On 26 January 2023, IPS issued a Consultation Document on the Proposed Amendments to the Insurance Distribution Rules to amend said Rules in line with findings observed during regulatory work as well as other findings observed by the market whilst carrying out their operations. Following the lapse of the consultation period and internal discussions held on the feedback received, on 8 August 2023 the MFSA issued a Circular and a Feedback Statement on the same proposed amendments to highlight the amendments made to the Insurance Distribution Rules and the applicability thereof;

- On 27 February 2023, IPS issued a Circular on EIOPA's Supervisory Statement on the Use of Governance Arrangements in Third Countries to Perform Functions or Activities. In this respect, the MFSA noted that EIOPA issued a Supervisory

Statement on the use of governance arrangements in third countries to perform functions or activities, which set out the expectations of EIOPA for undertakings and intermediaries making use of third country branches. It was noted that this Supervisory Statement requires undertakings and intermediaries to establish an appropriate level of corporate substance, proportionate to the nature, scale and complexity of their business. This Supervisory Statement applies to undertakings and intermediaries that are already conducting business and to those that are planning to launch operations. Following this, the MFSA informed the compliance officers of authorised insurance undertakings and enrolled and/or registered insurance intermediaries that they are expected to immediately bring this Supervisory Statement to the attention of the respective Board of Directors to ensure that they are meeting the expectation of the Supervisory Statement;

- On 12 April 2023, the MFSA published a 'Nature and Art of Financial Supervision document relating to an Initial Study on the Sustainability Related Website Disclosures in Terms of the Sustainable Finance Disclosure Regulation'. The aim of this document was to outline the MFSA's observations and corresponding preliminary compliance expectations regarding website disclosures, so that relevant entities can make the necessary improvements to the information published on their websites;

- In May 2023, CS published the 'Nature and Art of Financial Supervision relating to the Demands and Needs Assessment'. This document provides further guidance and outlines best practices in the context of the demands and needs assessment which insurance distributors are required to make in accordance with their regulatory requirements. Following the 'Demands and Needs Assessment Workshop' that was held in November 2022, on 10 May 2023 the Authority updated the 'Nature and Art of Financial Supervision – Conduct Supervision – The Demands and Needs Assessment' originally issued by the MFSA on 24 May 2022. The aim behind this update was to address and further clarify certain aspects on the manner in which a demands and needs assessment is to be conducted;

- On 25 May 2023, the MFSA issued a Circular on Amendments to References to the Conduct of Business Rulebook as laid down in Annexes to Chapter 9 of the Insurance Rules and Annexes to Chapter 16 of the Insurance Distribution Rules. These amendments are aimed primarily to update the references to relevant Rules of the Conduct of Business Rulebook currently found within the said Annexes, in order to ensure that such references are accurate and proper. Moreover, the said amendments also seek to align with the latest version of the Conduct of Business Rulebook, thus taking into account any ongoing changes that had been carried out in the Conduct of Business Rulebook which may have involved a renumbering exercise of certain rules within the Rulebook.

- On 16 October 2023, the MFSA issued a Circular on the Publication of New Applications for Individuals and Audit Firms to act as Approved Auditor. The MFSA presented Form AA43: Third Schedule - Application for Individuals to act as Approved Auditor and Form AA47: Fourth Schedule - Application for Audit Firms to act as an Approved Auditor, which replace the Third and Fourth Schedules listed under Chapter 4 of the Insurance Business Act. These new forms are aimed at further simplifying the application process, increasing efficiency and making the regulatory requirements clearer from the outset.

- On 7 November 2023, the MFSA issued a Circular on Structure and Composition of the Board of Directors, in which reference was made to the Corporate Governance Code issued by the MFSA on 5 August 2022. The aim of this Circular was to notify Insurance Agents and Insurance Brokers of the MFSA's expectations and approach regarding the implementation of the requirement emanating from paragraph 2.1.2.1.3 of the Corporate Governance Code.

- On 28 November 2023, the MFSA issued a Circular on the Reporting Requirements of Insurance Undertakings Adopting IFRS 17 – Insurance Contracts. The aim of this Circular was to notify Insurance Undertakings about the revised Quarterly National Specific Templates and Annual National Specific Templates, which may be found in Appendix I and Appendix II that were published together with this Circular. In this Circular, the MFSA noted that these revisions do not include any changes with regards to content, but only minor technical adjustments to facilitate the process of uploading onto the LH Portal.

- On 5 December 2023, the MFSA issued a Circular on Amendments to Chapter 8 of the Insurance Rules to Refer to New Implementing Regulations and New National Specific Templates. This follows the fact that on 4 April 2023 the European Commission issued two new Implementing Regulations, Commission Implementing Regulation (EU) 2023/894 and Commission Implementing Regulation (EU) 2023/895. These new Implementing Regulations repeal the Commission Implementing Regulation (EU) 2015/2450 and Commission Implementing Regulation (EU) 2015/2452 and shall apply from 31 December 2023. In view of the fact that reference was made in Chapter 8 of the Insurance Rules to Commission Implementing Regulation (EU) 2015/2450 and Commission Implementing Regulation (EU) 2015/2452, the MFSA amended the said Chapter to refer to the new Implementing Regulations.

1.5 Future Developments in the Regulatory Framework

In addition to the main regulatory developments outlined in the previous section, the MFSA also issued Consultation Documents in 2023 to propose a number of future developments to the regulatory framework in the insurance sector, as follows:

- On 22 February 2023, the MFSA issued a Consultation Document on the Amendments to the Insurance Business Act and the Insurance Distribution Act. The purpose of this Consultation Document was to highlight the changes proposed to be carried out to the Insurance Business Act and the Insurance Distribution Act in light of issues surrounding the exchange of confidential information. Following the lapse of the consultation period, the MFSA issued a Feedback Statement on 15 May 2023 on the comments received from the market in relation to the same. The MFSA is working on finalising the amendments to issue an updated version of the Insurance Business Act and the Insurance Distribution Act;

- Following a pre-consultation meeting held with the industry on 29 January 2021 and a workshop held at the MFSA premises on 17 April 2023, on 20 April 2023 the MFSA also issued a Consultation Document on the New Regime regulating Insurance Undertakings carrying on Long-Term Business and the Distribution of Contracts of Insurance as Retirement Products. The aim behind this proposed new regime is to regulate the retirement provision business of an authorised insurance undertaking carrying on long term business of insurance and the distribution of contracts of insurance as retirement products. The MFSA will also be consulting in the near future with the market on another legislative instrument to compliment the Consultation Document that has already been issued;

- On 13 September 2023, the MFSA issued two Consultation Documents, one on the Amendments to the Companies Act (Cell Companies Carrying on Business of Insurance) Regulations and one on a New Chapter 17 to the Insurance Rules entitled "Cell Companies carrying on Business of Insurance" and amendments to Chapter 5 to the Insurance Rules. The aim of these Consultation Documents is to address the fact that the procedures in relation to the transfer of cellular assets of a cell company and the liquidation of a cell in Subsidiary Legislation 386.10 Companies Act (Cell Companies Carrying on Business of Insurance) Regulations are not detailed. In order to do so, the MFSA proposed to amend the Companies Act (Cell Companies Carrying on Business of Insurance) Regulations and also to introduce a new Chapter 17 to the Insurance Rules to compliment the amended PCC Regulations which the MFSA aims at finalising in the near future.

- In addition to the regulatory developments, the process of which the MFSA has already commenced as outlined above, on 7 December the MFSA issued a Consultation Document on a number of proposed amendments to the Insurance Rules and the Insurance Distribution Rules. The aim of these proposed amendments is to ensure that the findings observed during regulatory work as well as other findings observed by the market whilst carrying out their operations are addressed by the MFSA.

MFSA's insurance Regulatory Framework will also continue to be developed to reflect EIOPA's main priorities which include digitalisation, cyber insurance, sustainable finance, consistent and high-quality supervision as well as the protection of consumers. During 2023, the MFSA also continued working on the transposition and implementation of the Digital Operational Resilience Act "DORA". The MFSA is also monitoring and providing feedback on the European single access point "ESAP" Regulation and ESAP Directive.

Furthermore, several changes in the supervisory framework are expected following the Solvency II 2020 review and the new IRRD proposal. These will include:

- A change in the method to extrapolate risk-free interest rates in order to avoid underestimation of technical provisions for insurance liabilities and setting wrong risk management incentives;
- Recognising in the Solvency Capital Requirement standard formula diversification effects with regard to matching adjustment portfolios and several changes to the design of the volatility adjustment to better align it with the objectives of the adjustment;
- A change to the calculation of the risk margin of technical provisions in order to reduce the sensitivity of the margin to interest rate changes and to recognise diversification of risk over time;
- A widening of the corridor to the symmetric adjustment to equity risk capital share in order to increase the effectiveness of this countercyclical measure;
- Refinements to the calculation of capital requirements for counterparty default risk and the recognition of risk-mitigation techniques;
- Risk-mitigation techniques – recognition of adverse development covers;
- Updating the risk factors for non-life insurance risks and clarifying the legal provisions on non-compliance with the Minimum Capital Requirement;
- The granting of powers to require a capital surcharge for systemic risk, imposing additional measures to reinforce the insurer's financial position (such as restricting or suspending dividend or other payments to shareholders), defining soft concentration thresholds, expanding the ORSA and the prudent person principle to take into account macroprudential concerns, drafting pre-emptive plans (recovery and resolution plans, as well as systemic risk and liquidity risk management plans), granting NCAs with additional mitigating measures for

liquidity risk in case vulnerabilities have been identified and imposing a temporarily freeze on redemption rights in exceptional circumstances;

- Supporting the efficient exchange of information among NSAs during the process of authorising insurance undertakings and in case of material changes in cross-border activities. EIOPA's role to be enhanced in the cooperation platforms that support the supervision of cross-border business where NSAs fail to reach a common view;
- A number of regulatory changes to address the current legal uncertainties regarding supervision of insurance groups under the Solvency II Directive;
- Streamlining and clarification of the expected content of the Regular Supervisory Report and of the Solvency and Financial Condition Report with the aim to support insurance undertakings in fulfilling their tasks and reducing the burden of such reports. Allowing groups disclosing a single SFCR to report to supervisors a single RSR. Auditing requirement ensuring that as a minimum the Solvency II Balance Sheet is subject in all Member States to external auditing by a qualified auditor. Extension of the deadlines of reporting and disclosure;
- Introducing clear quantitative criteria which identify low risk undertakings eligible for applying proportionality measures;
- Clarifying the legal framework, mainly on contract boundaries, the definition of expected profits in future premiums and the expense assumptions for insurance undertakings that have discontinued one product type or even their whole business;
- Reducing reliance on external ratings - possible additional methods allowing for a wider use of alternative credit assessments suitable for corporate exposures that are also rated by credit rating agencies;
- The introduction of the new IRRD proposing to introduce a number of new measures such as recovery measures including the request for pre-emptive recovery planning and the introduction of preventive measures. Relevant aspects around the resolution process include the designation of a resolution authority, the resolution objectives, the need for resolution planning and for a wide range of resolution powers.

Another future development in the regulatory framework that the MFSA aims at achieving in the insurance sector relates to the Retail Investment Package adopted by the European Commission on 24 May 2023. The aim of this package is to empower retail investors (i.e. "consumer" investors) to make investment decisions that are aligned with their needs and preferences, ensuring that they are treated fairly and duly protected. This will enhance retail investors' trust and confidence to safely invest in their future and take full advantage of the EU's Capital Markets Union. This Package includes amendments to the Insurance Distribution Directive and, in this regard, is particularly, but not exclusively relevant to manufacturers and distributors of insurance-based investment products. The envisaged changes of the EU Commission proposal on the

Retail Investment Package will inevitably lead to significant changes for the financial industry, particularly in relation to manufacturing and distribution processes, as well as to supervisory reporting. Therefore, the Authority is engaging with the various market players in order to familiarise themselves with these new proposed requirements and carefully assess their potential impacts on their entity's operations. In this regard, the MFSA is closely monitoring ongoing developments and plans to hold various engagements with the insurance market.

2. Supervision Priorities

During 2023, the MFSA has been primarily focusing its supervisory resources in relation to the following in line with the MFSA's Supervisory Priorities 2023:

2.1 Resilience of our Supervised Entities

Resilience of supervised entities is being primarily assessed by monitoring their financial soundness and by ensuring that risks which may cause a negative impact on their resilience are being identified, evaluated, monitored, controlled, and monitored on an ongoing basis. In light of this, the MFSA is mainly focusing on the following supervisory areas:

- Ongoing review of financials adopting a risk-based approach;
- Carrying out reviews and monitoring financial stresses in particular those relating to the current economic climate (such as but not limited to inflation and interest rates); and
- Assessing the effectiveness and maturity of the Risk Management System and Risk Management Function implemented.

2.2 Sustainable Finance

The MFSA believes that the insurance sector should play an important role in the mitigation and adaptation to climate change and sustainability risks. As also outlined by EIOPA, this sector has the responsibility to address sustainability-related challenges and facilitate the transition to a more sustainable and resilient economy.

In light of this, during 2023 the MFSA continued focusing its priorities on sustainable finance, by increasing the level of engagement with the respective entities to obtain a better understanding of how they will be embracing and implementing the integration of sustainable finance and ESG risks within their business strategy, governance and risk management framework their product oversight and governance processes and, where applicable, the sales process. The MFSA is engaging with supervised entities to obtain an understanding of how they are aligning themselves with the SFDR disclosure requirements. Furthermore, the MFSA is in communication with certain sectors of the insurance industry to share their plans of how they will be transitioning to a more sustainable model over a span of time.

The MFSA has also increased scrutiny of the assessment of climate-related risks in the ORSA and the extent to which undertakings have a sustainable business model in this regard. The MFSA is also monitoring undertakings to prevent greenwashing, in line with guidance provided by the EU.

The MFSA has also continued to monitor developments with respect to the requirements relating to Sustainable Finance which are applicable to insurance undertakings and insurance intermediaries. The MFSA is also working on integrating the new ESG factors in its supervision of insurance undertakings and insurance intermediaries and ensuring compliance by such entities with the relevant requirements. In order to do so, the MFSA is participating in an EU Technical Support Instrument (TSI) multi-country project, which will provide technical support on supervisory capacity enhancement in Sustainable Finance. The TSI project will seek to contribute to institutional, administrative, and growth-sustaining structural reforms in the four participating jurisdictions, by assisting national authorities to improve their capacity to design, develop and implement reforms, specifically by enhancing supervisory capacity in the field of sustainable finance. The multi-country format will allow for a tailor-made approach that considers national specificities, whilst harmonizing common aspects.

2.3 Digital Finance

Whilst the MFSA has integrated ICT supervision in its prudential assessments, it is also increasing scrutiny of risk management in relation to exposure to operational cyber risk in its ORSA review processes. One of the key aims is to increase awareness of the potential severity of risks.

The MFSA is also keeping a close eye on developments in terms of cyber insurance cover provided by insurance undertakings and whether the companies writing such risks (either explicitly or implicitly) have the adequate risk management framework in place to manage risks associated with writing this risk.

2.4 Sector Specific Priorities

Furthermore, the MFSA has also been focusing on the following:

- **Data quality (internal & external stakeholders)**

MFSA continued to prioritise data quality initiatives to ensure that data derived from both internal and external stakeholders is complete, accurate and reliable.

- **Training and mentoring of staff**

Employee training and development has been given a top priority during 2023 to ensure that MFSA employees will continue developing their personal and organisational skills, knowledge, and abilities with the aim of enhancing the overall supervisory effectiveness, efficiency and productivity. The structured training programme for 2023 has been primarily devised to address specific gaps in skills and knowledge of the team and will be constantly adapted according to meet the supervisory priorities of the MFSA. This will be complemented with ongoing mentorship tapping into the knowledge and experience already in place within the senior supervisory staff members.

- **Implementation of the IFRS 17**

In view of the complexities of IFRS 17 and that first audits will be carried out in 2024, the Authority allowed insurance undertakings to report management accounts on an IFRS 4 basis up to Q3 2023. In the meantime, work has continued to be carried out on the development of an alternative Local Generally Accepted Accounting Principles as a potentially simpler accounting alternative for certain insurance undertakings.

- **Transposition and implementation of the Motor Insurance Directive**

Directive (EU) 2021/2118 which was published in the Official Journal of the European Union, brought about significant amendments to the Motor Insurance Directive ("Directive 2009/103/EC") aimed at, inter alia, ensuring injured parties are protected through effective arrangements for compensation and improving the rights of policyholders, even where an insurer winds up due to insolvency. The transposition of such amendments necessitates discussions with the Government and with numerous market stakeholders. The MFSA has engaged in discussions with a number of interested and affected stakeholders. During 2023, MFSA continued engaging with the relevant stakeholders to finalise the transposition of the amendments to the Motor Insurance Directive.

- **Re-engineering processes and procedures of core supervisory activities**

To continue enhancing its supervisory efficacy, MFSA has selected a number of core supervisory activities which are undergoing a re-engineering process during 2023 to ensure that the supervisory practices remain at an optimal level of supervision achieving the desired outcomes whilst at the same time ensuring better operational flow and business continuity.

- **Streamlining existing legal and regulatory frameworks and optimising the effectiveness of supervisory processes**

To continue enhancing its supervisory efficacy, the MFSA has finalised and implemented a conduct risk model with a view to assigning a conduct risk rating to entities falling within the remit of Conduct Supervision. This will ensure that the supervisory engagements remain at an optimal level of supervision focusing the resources where it is required.

- **Carrying out thematic reviews in accordance with the Supervisory Priorities**

Thematic reviews are essential for the Authority in assessing the current market conditions including current or possible emerging risks.

The MFSA carried out a thematic review on Product Exclusions contained in the policy wording of specific insurance products to mainly assess whether the exclusions that are implemented in the policy wording are ensuring fair and consistent consumer outcomes. The MFSA also looked at how insurance manufacturers applied and abided by the Product Oversight and Governance ('POG') requirements when designing or significantly amending insurance products.

Other thematic reviews that commenced during 2023 are the Credit Protection Insurance, Sustainable Finance and PRIPPs KIDs. The common aim of these reviews is at guiding and encouraging entities to take the necessary corrective action where applicable.

- **Improving financial literacy and consumer awareness**

The MFSA will continue to take initiatives to promote greater consumer awareness on financial products and services. These initiatives include updating of information on its website, consumer education campaigns and engagement with the relevant stakeholders in this area.

3. Supervisory Engagement and General Observations Noted

The ever-changing regulatory landscape is putting greater emphasis on the importance for licence holders to implement a system of governance which facilitates effective oversight and a robust compliance and risk management culture which is embedded into the core of their businesses in order to ensure that the best interests of its clients are at the centre of the entity's operations. In this light, the MFSA aims to continue enhancing its supervisory processes and methodologies and maintain a wide coverage of on-site inspections focusing on a review and assessment of a number of areas (extended to group level in the case of insurance groups), primarily:

- the effectiveness of the system of governance including effective implementation of the key and critical/important functions and oversight of such functions;
- the fitness and properness of directors, senior management and key function holders;
- the effectiveness of the management, organisational and operational structures including the internal control system;
- the extent to which the undertakings and intermediaries act fairly, professionally and in accordance with the best interest of their clients, *inter alia* by ensuring that they have adequate product oversight and governance arrangements in place, avoiding conflicts of interest (or mitigating these when avoidance is not possible) and adhering to sales practices which put the customer's best interest at the forefront;
- process workflows relating to distribution, underwriting and claims management/handling;
- the effective implementation of the internal controls including oversight, reporting lines and information flows in relation to distribution, underwriting and claims;
- the end-to-end processes of claims handling and reserving;
- reserve methodology and its operational aspects including but not limited to data management, data availability and data quality;
- detailed walkthroughs of Management Information Systems used;
- reviewing and assessing the due diligence process implemented by undertakings including fit and proper assessments;
- capital planning;
- adherence to the Prudent Person Principle;
- the ORSA process;
- implementation of AML/CFT legislative requirements.

The Authority identified a number of common recurring weaknesses and shortcomings during the course of its supervisory activities including onsite inspections and thematic reviews. These are primarily based on a review of documentation provided as part of the onsite visit as well as discussions held with board members, senior management of the undertaking and the responsible key function holders. These include:

3.1 Governance

The MFSA noted general recurring issues in relation to the effective implementation of the system of governance. This includes the need for the Board of Directors to enhance further their current composition and collective competencies as well the need to implement formal reporting structures primarily with regards to board committees. The MFSA also noted that Board of Directors need to improve their understanding of the resilience of their business model to stress scenarios.

It has also been generally noted that undertakings need to better document minutes to also capture discussions and challenges that eventually led to the decisions taken.

Whilst generally boards allocate a considerable amount of time to discuss various important matters particularly those relating to strategy, business performance including key performance indicators and key risk indicators, less time is being dedicated during board meetings towards other important matters which include regulatory compliance matters, assessing the effectiveness of the performance of board committees and the performance of control functions falling in the 2nd and 3rd line of defence, assessing the overall effectiveness of the system of governance, risk management system and internal controls.

The Authority has also noticed that undertakings need to exert more effort to implement adequate and appropriate fit and proper assessments, whilst a number of undertakings are still struggling to understand how to conduct a review of the system of governance and what the expected outcomes are, when carrying out such review.

3.2 Compliance

The Authority has observed a number of weaknesses and deficiencies leading to an ineffective Compliance Function, ranging from individuals responsible for the Compliance Function who do not demonstrate a strong understanding and adequate knowledge of all the legal and regulatory requirements applicable to the undertaking or intermediary, to other issues such as inadequate resources, inadequate compliance plans, inadequate reporting to the Board on regulatory compliance matters, lack of timely reporting of material changes to the Authority, weak compliance with respect to the requirement of carrying out a Demands and Needs Test as well as weak assessments of Demands and Needs being conducted. The Authority also noted significant room for improvement with respect to compliance with Disclosure Requirements and Complaints Handling Arrangements.

3.3 Internal Audit

The Authority noted that generally Internal Audit Plans do not take into account all the activities and the complete system of governance; and/or do not capture all outsourced activities; and/or do not cover all significant activities that are to be reviewed within a reasonable period of time.

3.4 Monitoring of Distribution Network and Intermediaries given Delegated Underwriting and Claims Authority

The Authority has observed various issues in this respect. These include limited resources to carry out effective monitoring of the distribution network leading to the entire distribution network not being reviewed within a reasonable period of time. Generally internal controls in relation to distribution and claims handling were noted to require improvement. This includes inadequate or lack of documented procedures and manuals, delegated authority matrices including escalation and referral processes and reporting. Furthermore, it has also been noted on several occasions that the individual appointed to carry out oversight of delegated underwriting and claims activities demonstrates inadequate or ineffective oversight.

3.5 Reserving and Claims Handling

On a number of occasions, the Authority noted weak governance relating to reserving and claims handling. It has been noted that documentation in relation to the reserving process, assumptions and methodology, audit checks, procedures of claims handling, processing and oversight lacks detail. Audit trails are not always properly documented whilst internal controls around the reserving processes, claims handling, governance of data in particular data integrity and the type of data checks carried out are not always properly documented.

3.6 Business Continuity

On various occasions the Authority noted that contingency plans are not being regularly tested, reviewed, and updated by undertakings. The Authority noted a number of inadequate or poorly documented contingency plans primarily due to the lack of an appropriate business impact analysis. Furthermore, the Authority notes with concern that contingency plans generally did not include exit strategies for outsourced critical or important functions or activities.

3.7 Complaints Handling

Further to a number of onsite inspections focussing on the complaints handling procedures of insurance undertakings, the Authority has noted a number of shortcomings mainly relating to the maintenance of a detailed and organised complaints register, lack of adequate monitoring of intermediaries distributing the undertaking's products to ensure that they adhere to the complaints handling policy and procedures of the outsourcing undertakings.

Furthermore, the Authority also noted that in certain instances, undertakings did not dedicate sufficient resources to deal with the complaints received. This often contributed to the fact that the applicable regulatory time frames for correspondence with complainants were not being met.

The Authority also notes with concern that an effective root-cause analysis of complaints data and management information relating to complaints was, at times, found to be lacking. This led to undertakings having no procedure to identify and address any recurring patterns, systemic problems, and potential legal and operational risks.

3.8 Disclosure Requirements by Tied Insurance Intermediaries

In a number of inspections carried out on Tied Insurance Intermediaries, the Authority also noted that although PIDs and KIDs are being distributed, there was lack of awareness among Tied Insurance Intermediaries as to the contents and purpose of this document. It was also observed that Tied Insurance Intermediaries were not sufficiently knowledgeable about certain pre-contractual disclosures which they are bound to provide to clients, mainly relating to the existence and purpose of the Protection and Compensation Fund, the procedure to be followed in case of complaints and the role of the Arbiter for Financial Services.

3.9 Assessment of Demands and Needs

During its supervisory interactions with insurance intermediaries and insurance undertakings which distribute insurance products, the Authority has observed a lack of understanding of the demands and needs assessment which distributors of insurance products are required to make in terms of Article 20 of the Insurance Distribution Directive as transposed in the Conduct of Business Rulebook.

In many cases reliance to determine the client's demands and needs was made on the replies provided by the latter when filling in the proposal form. This is not considered to be adequate given that the questions contained on this form serve to enable the insurer to decide whether it is acceptable to underwrite that client's risk. On the other hand, the demands and needs assessment is to be carried out by the insurance undertaking or intermediary prior to the actual provision of the service in order to ensure that the insurance cover being proposed does in fact meet the client's demands and needs. Therefore it is expected that certain additional questions to those ordinarily included in a proposal form, and which would be particularly targeted to determine the client's insurance needs would also be made in order for an effective demands and needs assessment to be carried out.

On this matter, the Authority has extensively engaged with the industry and issued a Nature and Art Document on this topic on 10 May, 2023.

3.10 Exclusions in Insurance Products

The MFSA conducted a thematic review in order to assess whether the exclusions that are implemented in the policy wording of specific insurance products are ensuring fair and consistent consumer outcomes. In this context, insurance manufacturers were expected to apply and abide by the Product Oversight and Governance (POG) requirements, when designing or significantly amending insurance products. The Authority held various exchanges with licence holders involved in the thematic review in order to highlight the good and bad practices that resulted from the review as well as pointing out the expectations of the Authority in this regard.

3.11 AML and CFT Risk Oversight

The MFSA, in its role as an agent for the FIAU, will continue to integrate the AML and CFT aspect in its supervisory workplans. In this context the Authority will continue to carry out certain checks with respect the knowledge, training and business model of insurance undertakings and intermediaries which are subject to the Prevention of Money Laundering Act, (Cap. 373) and/or the provisions amending the Act, and/or the Regulations made thereunder, and/or the Implementing Procedures and any guidance notes issued by the Financial Intelligence Analysis Unit.

4. Supervisory Focus

The Authority has and will continue placing emphasis on the following aspects also taking into account the MFSA Supervisory Priorities and the EIOPA's Strategic Priorities:

- Governance and Compliance Culture including the effective implementation of the internal control system;
- Outsourcing;
- The continued enhancement of the integration of financial crime assessments in prudential assessments;
- Maintaining a strong focus on business models that rely heavily on cross-border operations as well as continue to maintain close collaboration with regulators in host Member States and European peers to ensure effective cross-border supervision of such regulated entities;
- Maintaining ongoing monitoring of prudential requirements relating to capital adequacy, business model profitability, liquidity and general financial soundness of regulated entities;
- Monitoring and identification of financial stability risk and mitigation of external risks by regulated entities;
- Ensuring effectiveness of compliance activities;
- Conducting a thematic Review into the expected profits in future premiums (EPIFP);
- Conducting supervisory reviews on liquidity;
- Conducting deep-dive assessments of Technical Provisions and overall Pillar I requirements of selected Licence Holders;
- Conducting deep-dive assessments of Reinsurance arrangements of selected Licence Holders;
- Data quality of regulatory reporting;
- Prudential and conduct aspects relating to Insurance Based Investment Products, including With Profits Products;
- Carrying out a critical assessment of counterparty default risk, which will cover appropriateness of CDR SCR under the Standard Formula, potential consequences of ageing of debtors and suitable scenario testing as part of the ORSA;
- A market wide assessment of the appropriateness of the amount of expenses accounted for as part of the Solvency II Technical Provisions;
- The carrying out of insurance distribution activities by insurance brokers and agents. Specifically, the Authority will be assessing how brokers and agents carry out fair analysis, where applicable, demands and needs testing and the placing of business with undertakings;
- The handling of claims by insurance undertakings.

- The distribution of insurance products by banks (Bancassurance); and
- The application of undertakings' product oversight and governance requirements in practice with regard to the target market assessment, product testing and product monitoring and review and the selection of distribution channels.
- Assessing the entity's Key Information Documents ("KIDs") under the Packaged Retail and Insurance-Based Investment Products ("PRIIPs") Regulation
- Assessing the local market following the outcomes of EIOPA's own thematic review on Bancassurance related to Credit Protection Insurance (CPI) products,
- Assessing the entity's integration of sustainability preferences following the Authority's request for information of the 5th of October 2022 on the Insurance Distribution Directive (IDD) suitability requirements

Concluding Remarks

In this document the Authority has indicated the areas which it will continue focusing on in relation to the supervision of entities. Furthermore, this document also provides a list of common recurring weaknesses and shortcomings that have been identified by the Authority during the course of desk-based and on-site inspections carried out. It is to be noted that the matters highlighted in this document are not exhaustive and it remains the ultimate responsibility of the regulated entity to ensure that it complies with its applicable regulatory requirements at all times.

Insurance Undertakings and insurance intermediaries are expected to review their own governance, risk and compliance structures, including the internal control system, undertake an assessment, and take the necessary action to address any deficiencies and shortcomings, including financial deficiencies, in a timely manner.

The Authority will be following-up supervisory work to assess the overall improvement achieved by the respective undertakings and intermediaries in addressing any deficiencies and shortcomings identified.

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