The New Corporate Governance Framework for Mexican Insurers

Leonel Pereznieto del Prado



Creel, García-Cuéllar, Aiza y Enríquez, S.C.

Allan Galileo Olmedo Villegas



I. General Overview of the New Insurance Legislation

After a transition period of two years, the new Insurance and Surety Institutions Law (*Ley de Instutuciones de Seguros y Fianzas*) (the "LISF") will enter into force on April 4, 2015. The most important objective of the LISF is to implement the Solvency II framework in Mexico. Also, a very important development from a structural perspective is that the regulatory and supervisory for the insurance and surety sector - which had been shared amongst the Ministry of Finance and Public Credit ("SHCP") and the National Insurance and Surety Commission ("CNSF") - will be consolidated into the latter while the SHCP will retain certain policymaking authority for the sector.

The LISF also rearranges the statutory language and structure of Mexican insurance legislation, which had become confusing and redundant after multiple and disorderly amendments introduced over time. Moreover, the LISF merges two separate statutes that applied to the insurance business on the one hand and the surety business on the other: the General Law of Insurance Institutions and Mutual Companies (*Ley General de Instituciones y Sociedades Mutualistas de Seguros*) ("LGSIMS") and the Federal Surety Institutions Law (*Ley Federal de Instituciones de Fianzas*) ("LFIF"). Such convergence of the insurance and surety business is also reflected in the creation of the new "surety insurance" (*seguro de caución*) line of business by the LISF.

The transition period contemplated for the LISF allowed for the drafting and implementation of the Unified Insurance and Surety Regulations (*Circular Unica de Seguros y Fianzas*) ("CUSF"), which details the principles contained in the LISF. The CUSF were published on December 19, 2014 and are also scheduled to become effective on April 4, 2015. Pursuant to its transitory provisions the CUSF sets forth a further transition period for Pillars 1 and 3 of the Solvency II framework which will become effective; namely, the provisions of the LISF and CUSF relating to quantitative and disclosure requirements are postponed until January 1, 2016. Such postponement, however, is not extensive to Pillar 2 of the Solvency II framework which implements the Supervisory Review mechanism

In a manner consistent with Pillar 2 of Solvency II, and specifically with the internal assessment process of risks and solvency, known as the ORSA (*Own Risk and Solvency Assessment*), the provisions of the LISF revamp the internal corporate governance and supervisory system for insurance and surety companies in Mexico. This article takes a closer look into the implementation of Pillar 2 as contemplated in the LISF and CUSF. In general, all references to insurance institutions in this article may be understood as being made to surety institutions as well.

II. The New Corporate Governance Framework

A. Duties and Responsibilities of the Board

One of the innovative features of the LISF and the CUSF is the increased supervisory powers and responsibilities of the board of directors.

In the LGSIMS and LFIF, the role of the board of directors was considerably narrower than the broader scope now set forth in the LISF. Namely, under the prior legislation, the board was responsible for approving and defining the policies and guidelines for both the business/operational departments and the compliance areas of the company, and for creating committees conformed by officers of the company who were responsible for deliberating about such business/operational departments and compliance areas. In parallel, the supervision of regulatory compliance was the responsibility of a "normative comptroller" who had to be an independent individual duly authorised to act as such by the regulator. Therefore, from a compliance supervision perspective, the role of the board was practically limited to reviewing and approving the deliberations and findings of the committees and of the normative comptroller.

Accordingly, the role of the board of directors under the legislation that is being phased out by the LISF was rather passive and heavily reliant on the reports of the committees and the normative comptroller. This effectively shifted the responsibility for the adequate functioning of compliance supervisory functions to the officers appointed to the committees who would be on the frontline of liability in case the committee failed to flesh out relevant compliance issues. The normative comptroller, on the other hand, was subject to liability *vis-à-vis* the regulator who could impose fines and even revoke its authorisation to act as such, if his/her functions were not carried out properly. Thus, the LISF created few incentives for the board's involvement in ensuring that the compliance supervisory roles were working adequately and for becoming actively involved in such roles. In other words, the LGISMS and the LFIF favoured an approach where the directors were able to comply with their responsibilities while limiting their purview to the four corners of the reports of the committees and the normative comptroller, without having to actively inquire into the process whereby such reports were produced.

In contrast, Article 70 of the LISF substantially expands the authority and responsibilities of the board of directors. In addition to approving and defining the policies and guidelines for the business/operational departments as well as the compliance areas

and creating committees - as was the case under the legislation preceding the LISF - the board is now charged with the duty to establish mechanisms for permanently verifying compliance with quantitative requirements of the insurance company. It is also responsible for permanently ensuring that the ORSA assessment process is working properly. Accordingly, the board of directors of the insurance company is no longer a passive receiver of reports but, instead, must be actively involved in the adequate functioning of the cyclical and iterative system for verifying compliance against risks.

Also, consistently with this approach of "hands-on" involvement of directors, the role of the "normative comptroller" is replaced with an audit committee which is responsible for verifying compliance with the internal policies and guidelines (including those implementing ORSA) and with laws and regulations. The Audit Committee must be composed of three or five directors at least one of which must be an independent director. The Audit Committee must meet, at least, on a quarterly basis and report its findings to the board. Therefore, the board, through some of its members that are required to act as members of the Audit Committee, is required to take an active role in scrutinising legal and regulatory compliance.

As regards the requirements for the conformation of the board itself, the principles contained in the LISF had already been laid out in the each of the LGISMS and the LFIF. Namely, the board must be formed by at least five, but no more than fifteen, directors, of which at least 25% must be independent. As described in section D below, however, there are certain new requirements that apply to the conformation of the board depending on the relationship with affiliates.

B. Implementation of Second Pillar

Article 69 of the LISF sets forth the basis for the implementation of the Second Pillar of the Solvency II framework which is regulated in further detail in Section 3 of the CUSF. Accordingly, the new LISF and the CUSF regulations lay out the process for the internal assessment of risks and solvency, known in the Solvency II jargon as the Own Risk and Solvency Assessment ("ORSA"). To that effect, at least, the following five "functions" must be put into place in a manner that is adequate for performing such assessment:

(i) Integral Risk Management Function, is charged with producing risk management guidelines and designing and implementing the methodology to, continuously, identify, measure, follow up, mitigate, limit and control the different types of risks, as well as correct any deviations from the risk parameters adopted;

(ii) Internal Control Function, is responsible for setting up and maintaining the necessary measures and controls to ensure that the operations carried out by the various operational areas of the insurance company is in compliance with the existing internal policies and with the applicable legal and regulatory provisions;

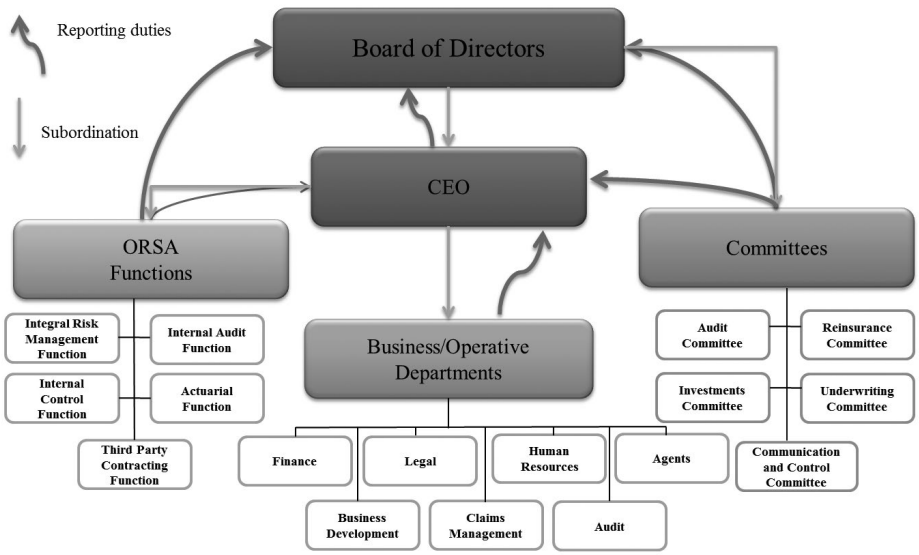
(iii) Internal Audit Function, is responsible for verifying that the policies and procedures approved by the board of directors, as well as legal and regulatory requirements have been duly applied and complied with, and for running selective tests to ensure the sufficiency, reasonability and consistency of the financial, technical and statistical information. To that effect the Internal Audit Function must be afforded complete access to all documents and files relating to the company's business, and must have close communication with the Audit Committee;

(iv) Actuarial Function, its role is essentially to check the actuarial design of products and their technical viability and to verify the calculation and valuation of technical reserves, as well as to inform management of the reasonability and reliability of such calculations; and

(v) Third Party Contracting Function, must implement the mechanisms for verifying that third party vendors and contractors of the insurance company comply with financial, technical, administrative and legal capabilities required for rendering the services and to scrutinise conflict of interest with respect to such vendors and providers.

Pursuant to the LISF, the ORSA mechanism maintained by the insurance company must be commensurate to the volume of its operations and the complexities and nature of its business. Also, the LISF requires that the organisational structure in place for the each of the functions to be transparent and provide for an adequate and clear assignment of roles, and to ensure that the Integral Risk Management Function, the Internal Control Function and the Internal Audit Function are afforded sufficient independence from operational departments of the insurance institutions in order to appropriately carry out their tasks. Also, the persons serving at the Internal Control Function may not be simultaneously engaged in the Internal Audit Function or in any other function or area that may present a conflict of interest with the latter. Finally, the ORSA system as a whole must be maintained in good working order and for that purpose is subject to an annual internal review by the board of directors.

The interplay between the ORSA functions and the other corporate governance structures of an insurance institution under the LISF is illustrated below:



C. Officers

Article 58 of the LISF (in the same terms as Article 29 VII Bis-1 of the LGISMS) expressly contemplates the appointment of a Chief Executive Officer (Director General) of an insurance institution and sets forth the requirements that such officer must comply with. Article 58 of the LISF also sets forth the requirements that officers that are appointed to the two levels subordinate to the CEO must comply with. The appointment of officers appointed to the two tiers below the CEO is optional as Article 62 of the LISF provides that insurance institutions will conduct its corporate purpose through one or more officers that are appointed to that effect. Because the LISF (as the LGISMS does today) confers binding authority to appointed officers, it recognises that appointments may vest only on a few of the employees of the insurance institution and in any event at least on one of them who holds the position of CEO.

In the context of the implementation of the Second Pillar as described in Section B above, the LISF does not require the appointment of specific officers for each of the "Functions" except for the CEO and, considering the independence required, an officer that is responsible for the Integral Risk Management Function. The CUSF expressly requires that the CEO be the head of the Internal Control Function and the Third Party Contracting Function. As regards the Audit Function and the Actuarial Function, the same may be entrusted to employees of the insurance institution that can show the necessary capacities and expertise for performing such functions.

D. Committees

The LISF and CUSF preserve the requirements set forth in the LGISMS for insurance companies to designate advisory committees which will report directly (or by means of the CEO) to the board of directors, however, the authority and responsibilities of the committees are expanded by the enactment of the LISF. This is because, in addition to the advisory role before the board which is maintained, the committees are now charged with the duty to support the board to operate, supervise and evaluate the policies and strategies implemented in light of the new corporate governance framework described in Section B above. For such purposes, as per statutory provisions, the LISF requires for each insurance company to establish three advisory committees, namely: (i) an Audit Committee, which has been described in section II.A; (ii) an Investments Committee; and (iii) a Communication and Control Committee. Also, the LISF requires the establishment of additional specialised Committees, namely a Reinsurance Committee to the extent the relevant insurance company conducts reinsurance operations and an Underwriting Committee for insurers engaged in mortgage insurance and financial guaranty insurance.

The Audit Committee and the Underwriting Committee (in the specific lines of business where the latter is required) seem redundant with the ORSA functions identified in section II.B above. On the other hand, the Investment Committee - which is responsible for analysing the investments of technical reserves and solvency capital - the Communications and Control Committee - that overlooks anti-money laundering controls - and the Reinsurance Committee focus on specialised aspects of the business with less of an overlap.

E. Affiliate Relationships

The LISF and CUSF set forth a new legal framework applicable to relationships amongst insurance institutions and their affiliates, which was not regulated in such detail in the LGISMS. Articles 86 through 89 of the LISF, set forth a series of complex rules that are aimed at ensuring that the corporate governance of Mexican insurance companies is independent to that of persons or entities with which they have "Patrimonial Links" (*Vínculos Patrimoniales*) (i.e., affiliated companies)[1] or "Business Links" (*Vínculos de Negocios*) (i.e., joint venture participations).[2] For such purpose, the LISF also lays out the concept of Consortium and Group of Companies.[3]

Specifically in connection with the conformation of the board of directors, the new legal provisions applicable to affiliate relationships allow for the majority of directors to be persons that belong to the same Consortium or Group of Companies or have Patrimonial Links or Business Links. Of such majority of directors, however, the directors related to persons that have Patrimonial Links or Business Links may not conform the majority, whereas officers of persons that belong to the same Consortium or Group of Companies are allowed to conform such majority. For example, in a five-member board, two directors may also be officers of other companies of the same Consortium or Group of Companies, one director may be related to a person that has Patrimonial Links or Business Links and two directors must be independent.

As regards the officers, Article 88 of the LISF provides that the CEO of an insurance company and officers serving on the top two tiers below the CEO, may not be simultaneously officers of a company pertaining to the same Consortium or to the same Group of Companies. This provision, which is unduly broad, may present issues for leveraging on human resources that may be acting as officers in affiliated companies, thus giving rise to inefficiencies that nonetheless can be surmounted by carefully staffing the institution's personnel while complying with the new regulatory framework.

Endnotes

1 The LISF defines "Patrimonial Link" as the one that derives from pertaining to a "Consortium" or "Group of Companies".

2 The LISF defines "Business Link" as the one that derives from the execution of co-investment agreements in other companies or any other type of agreement by means of which the direct or indirect control over 20% of the voting shares is attained.

3 Pursuant to the Insurance and Surety Institutions Law, a "Consortium" is defined as the group of companies linked among themselves by one or more entities that integrate a group of companies, have the control of the first mentioned companies (i.e., Control is deemed as more than 50% of the voting rights with respect of capital stock, or directly or indirectly manage the main strategy and polities of the insurance and surety institution). On the other hand, "Group of Companies" is defined as companies organised under a direct or indirect scheme of participation in the capital stock, in which a sole company maintains the control of such companies.



Leonel Pereznieto del Prado
Creel, García-Cuéllar, Aiza y Enríquez, S.C.
Paseo de los Tamarindos 60, 3rd Floor
Bosques de las Lomas
05120 Mexico D.F.
Mexico

Tel: +52 55 4748 0614
Fax: +52 55 4748 0660
Email: leonel.pereznieto@creel.mx
URL: www.creel.mx

Leonel Pereznieto is a partner of Creel, García-Cuéllar, Aiza y Enríquez and heads the firm's insurance and reinsurance group.

Leonel's practice brings together a unique insight into Mexican insurance and reinsurance laws and a global outlook driven by a demanding international clientele. His broad expertise in direct insurance - including marine - cuts through contentious, transactional and regulatory aspects, with a particular emphasis on creating structures for innovative product lines and business arrangements for the Mexican market. On the reinsurance front, he represents reinsurers in connection with contentious and contract issues in Mexico and in other Latin American countries, as well as global reinsurance brokers on their regional business.

Leonel is admitted to practice in Mexico and New York and is a member of the Insurance Committee of the International Bar Association. He authored the article entitled "Terrorism Insurance in Mexico in the Age of Drug Wars: a Perspective for Reinsurers" in the Euromoney 2011/2012 International Reinsurance Review and published the article entitled "Must Global Insurers get Dragged into Litigation in Mexico in the Euromoney 2012/2013 *International Reinsurance Review*.



Allan Galileo Olmedo Villegas
Creel, García-Cuéllar, Aiza y Enríquez, S.C.
Paseo de los Tamarindos 60, 3rd Floor
Bosques de las Lomas
05120 Mexico D.F.
Mexico

Tel: +52 55 4748 0629
Fax: +52 55 4748 0660
Email: allan.olmedo@creel.mx
URL: www.creel.mx

Allan Olmedo is an associate of Creel, García-Cuéllar, Aiza y Enríquez and is a member of the firm's insurance and reinsurance practice group. He specialises in regulatory compliance, corporate governance and licensing process of direct insurers, insurers' brokers and reinsurers before the Mexican Ministry of Finance and the Mexican Insurance and Bonding Commission. He also advises worldwide insurance institutions in start-up transactions within Mexican territory and in the sale of innovative insurance products. Allan's experience includes advisory in claims and coverage disputes. Allan has been actively involved in M&A transactions involving the purchase and sale of Mexican operations of insurance institutions and international reorganisations of insurance groups.

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