ICP 4: The Supervisory Process

Basic-level Module
The module was prepared by Mr. John Thompson, a private consultant based in Toronto, Canada, who provides advice and functional support to financial sector regulators, the financial services industry, and educational organizations. He is the chairman of the Insurance Advisory Group for the Toronto International Leadership Centre (which is based in Toronto, Canada, and provides leadership development training for financial sector regulators). He is an actuary with more than 24 years of experience in senior positions within a life insurance company, both in Canada and the United Kingdom. Prior to becoming a consultant, he was deputy superintendent at the Office of the Superintendent of Financial Institutions in Canada. He also has broad experience at the international level as the former chairman of the Executive Committee of the International Association of Insurance Supervisors and member of the Basel Committee for Banking Supervision.

The paper was reviewed by Ms. Monika Jurášová, from the Czech Republic, and Ms. Hauw-Quek Soo Hoon, from Singapore. Ms. Jurášová, currently working in the insurance sector, has spent 10 years with the Office of State Supervision of Insurance and Pension Funds and the European Bank for Reconstruction and Development. Ms. Hauw-Quek was formerly executive director of the Insurance Supervision Department at the Monetary Authority of Singapore (MAS), where she represented the MAS on the IAIS Executive Committee and was also chair of the Education Subcommittee.
Contents

About the Core Curriculum .................................................... v

Note to learner ................................................................. vii

Pretest ............................................................... ix

A. Introduction ................................................................. 1

B. Supervisory mandate ..................................................... 7

C. Supervisory methodology ............................................... 8

D. Supervisory reliance on the work of others ......................... 29

E. Accountability ............................................................... 32

F. Transparency ............................................................... 33

G. Consistency ................................................................. 36

H. Conclusion ................................................................. 37

I. References ................................................................. 41
Appendix I. ICP 4: Supervisory Process ........................................... 43

Appendix II. Answer key................................................................. 45

Figures

Figure 1. Analysis and inspection work flow .................................... 10
Figure 2. The range of supervisory approaches ............................... 12
Figure 3. Cross-sector study ......................................................... 16
Figure 4. Risk-focused approaches. ................................................. 17
About the Core Curriculum

A financially sound insurance sector contributes to economic growth and well-being by supporting the management of risk, allocation of resources, and mobilization of long-term savings. The insurance core principles (ICPs), developed by the International Association of Insurance Supervisors (IAIS), are key international standards relevant for sound financial systems.

Effective implementation of the ICPs requires skilled and knowledgeable insurance supervisors. Recognizing this need, the World Bank and the IAIS partnered in 2002 to develop a “core curriculum” for insurance supervisors. The Core Curriculum Project, funded and supported by various sources, accelerates the learning process of both new and experienced supervisors. The ICPs provide the structure for the core curriculum, which consists of a set of modules that summarize the most relevant aspects of each topic, focus on the practical application of supervisory concepts, and cross-reference existing literature.

The core curriculum is designed to help those studying it to:

- Recognize the risks that arise from insurance operations
- Know the techniques and tools used by private and public sector professionals to identify, measure, and manage these risks
- Operate effectively within a supervisory organization
- Understand the ICPs and other IAIS principles, standards, and guidance
- Recommend techniques and tools to help a particular jurisdiction observe the ICPs and other IAIS principles, standards, and guidance
- Identify the constraints and identify and prioritize supervisory techniques and tools to best manage the existing risks in light of these constraints.
Welcome to the ICP 4: Supervisory process module. This is a basic-level module on supervisory process that does not require specific prior knowledge of this topic. The module should be useful to either new insurance supervisors interested in understanding how the processes of the supervisor are defined and affect their day-to-day work or experienced supervisors who have not dealt extensively with the topic or are simply seeking to refresh and update their knowledge.

Start by reviewing the objectives, which will give you an idea of what you will learn as a result of studying the module, and answer the questions in the pretest to help gauge your prior knowledge of the topic. Then proceed to study the module either on an independent, self-study basis or in the context of a seminar or workshop. The amount of time required to study the module on a self-study basis will vary, but it is best addressed over a short period of time, broken into sessions on sections if desired.

To help you engage and involve yourself in the topic, we have interspersed the module with a number of hands-on activities for you to complete. These are intended to provide a checkpoint from time to time so that you can absorb and understand the material more readily and apply it to the local situation and related practices in your jurisdiction. You are encouraged to complete each of these activities before proceeding with the next section of the module. An answer key in Appendix II sets out some of the points that you might consider when undertaking the exercises. If you are working with others on this module, develop the answers through discussion and cooperative work methods. Since these responses will vary by jurisdiction, the answer key suggests where you might look for the answers.

As a result of studying the material in this module, you will be able to do the following:
1. Summarize the requirements of ICP 4
2. Identify the fundamental components of a sound supervisory process
3. Explain what it means to have transparent supervisory and regulatory processes
4. Enumerate the benefits and potential costs of transparency for a supervisory authority
5. Describe a variety of methods that a supervisory authority might use to disclose information and explain the advantage and disadvantage of each
6. Describe the types of information that generally should be included in an annual report of a supervisory authority
7. Describe the types of information that a supervisory authority might appropriately provide on the financial situation of the insurance industry and major developments in the insurance and financial markets as well as the types of information that might be inappropriate to disclose
8. Illustrate the controls that a supervisory authority might establish to ensure the consistent and equitable application of regulations and administrative procedures
9. Illustrate how a supervisory authority, and the supervisory process, might be structured to facilitate the ability to take action immediately in the case of an emergency
10. Enumerate the methods that might be used to hold a supervisory authority accountable for its decisions
11. Describe the processes that might be established to appeal supervisory decisions and explain the tradeoffs that such processes present.
Before studying this module on the supervisory process, answer these questions. The questions are designed to help you gauge your existing knowledge of this topic. An answer key is presented in appendix II at the end of the module.

For each of the following questions, circle the response that is correct. For each question only one response is valid.

1. The term “supervisory process” refers to:
   a. The internal procedures used by supervisors to move files from one department to another within the supervisory authority
   b. The processes that supervisors use to review the operations and results of regulated insurers
   c. The procedures set out in the legislation that supervisors must follow
   d. The process for licensing new insurers
   e. A structured inspection process that identifies weak insurers.

2. When making a significant change in the rules that apply to insurers, a supervisor should consult with the industry before implementation because:
   a. That is the polite thing to do
   b. Insurers are likely to complain if they are not consulted
   c. The new rules are likely to be more readily followed
d. The insurers know the market best

e. The supervisor can always use good advice.

3. **Transparency of the procedures used by an insurance supervisor means:**

   a. Doing the work in a manner that allows people to see what is being done

   b. Letting the company review the work of the supervisor before completion

   c. Releasing a description to the public clearly setting out the supervisory process

   d. Using the same procedures that companies use to ensure that they are in compliance with the law

   e. Writing a policy paper for the staff so they know the limits of their decisionmaking authority.

4. **What powers or responsibilities might the mandate of the supervisory authority include?**

   a. To hire staff

   b. To contribute to public confidence in the financial system

   c. To prevent insurers from failing

   d. To operate within budget

   e. To keep its operations secret.

5. **When a supervisor makes an enforcement decision against an insurer, it should:**

   a. Be consistent with other decisions made for similar offenses

   b. Be a penalty for violating the rules

   c. Reflect the privilege that insurers enjoy

   d. Support the staff of the supervisory authority

   e. Be punitive and increase discipline in the system.
A. Introduction

This module is a basic-level module and, as such, is aimed at members of the supervisory staff who seek to understand the terminology of supervision and the basic concepts behind the core principles and the role of insurance supervisors.

The job of insurance supervisor covers a broad span of functions including, for example, licensing, requesting and receiving information, inspection, enforcement, and management of the orderly market exit of weak companies. However, the term supervisory process refers to the functions that relate specifically to the direct oversight and supervision of licensed market participants. These include all of the processes and procedures that supervisors use to review the operations of licensed insurers. These processes include receiving information from the insurers, reviewing it, carrying out analysis and inspections, forming a supervisory view of the strength of the insurer, and enforcing corrective action whenever that is required. In general, supervisory processes cover the work that is directed at licensed insurers.

The supervisory function can be carried out using a number of approaches, and some of these are described in this module. No matter which approach is adopted, the processes must be structured, documented, understood by the staff of the supervisory authority and the regulated insurers, and applied in an even-handed and consistent manner.

The degree of understanding and acceptance of the processes and the consistency of their application to all insurers affect the level of acceptance that insurers have of the decisions made by the supervisory authority. It is therefore important for supervisory authorities to publicize the processes and practices they have adopted and how deci-
sions and enforcement actions are determined within the authority. This transparency contributes to the confidence that the general public, the legislative branch of government, and the insurers place in the supervisory authority and the insurance sector.

Insurance supervisors receive their mandate from the legislative branch of government through the insurance legislation and are accountable to the government for carrying out the functions described in the legislation. Accountability should be tightly linked to responsibility and require the authority to report the most significant decisions made and the impact of these decisions on the achievement of supervisory objectives. A part of accountability requires responding to questions from the government and justifying the actions and decisions taken. This accountability is an important part of the supervisory authority’s contribution to the confidence that the legislative branch and the public at large have in the financial system in general and the insurance sector in particular.

This module develops these concepts and sets out some of the techniques that supervisory authorities use for meeting accountability requirements.

**Commonly used terms**

Most of the terms used in this module are intended to hold their common meaning. The IAIS *Glossary of Terms* includes definitions of terms that relate to supervision and provides clarity in interpreting the core principles, standards, and guidance notes that have been issued by the IAIS. In addition, certain terms used in this module are intended to have a specific meaning. The principal terms are defined as follows:

- **Accountability.** The requirement and ability to report and explain how an assigned responsibility was carried out.
- **Mandate.** A brief, clear definition of the range of decisionmaking and enforcement authority for which the supervisory authority is accountable.
- **Market conduct.** The aspects of the insurance market related to the contact with and representations made to the general public, policyholders, or claimants by insurers and intermediaries.
- **Prudential supervision.** The aspects of the insurance market related to the financial strength of insurers, the soundness of their operations, their ongoing viability, and their continued ability to meet their obligations to policyholders and claimants as they fall due.
- **Supervisory process.** The methodology that an insurance supervisor uses to oversee the operations of licensed insurers and intermediaries, assess the financial condition of licensed insurers, and take preventive and corrective measures.
- **Transparency.** The open and full disclosure of information by one party to all other parties that are affected by or interested in the activities of the first party.
The core principle

ICP 4: Supervisory process

The supervisory authority conducts its functions in a transparent and accountable manner.

ICP 4 on the supervisory process is reproduced, in full, in appendix I. While it is important to read and understand the text of this core principle, each person is encouraged to read all of the core principles to gain an appreciation of the scope of the powers that insurance supervisors should have to be effective.

ICP 4 focuses on the significance of having supervisory practices and procedures that are understood by the people and groups affected by them and supervisory authorities that are accountable for the decisions and actions taken in carrying out their duties.

The explanatory note includes four paragraphs to provide some background and explain different aspects of this topic.

Paragraph 4.1 requires supervisors to consult with representatives of the regulated entities on the supervisory processes they intend to apply, to document the processes, and to make this documentation available to the public. Active and considered consultation with the parties that are directly affected by changes in regulatory practices is an effective way of gaining understanding and support for the reforms from the people involved. This ICP does not imply that regulated insurance enterprises should define the supervisory processes; rather it requires active involvement of the supervisor and the regulated entities in defining how the supervisory methodology should work. This process of consultation helps the regulated entities to understand the rationale for the processes and strengthens their appreciation of the supervisory practices and procedures. This contributes to a more effective and consistent supervisory system.

Paragraph 4.2 requires the supervisor to make public the text of current and proposed regulations, rules, and interpretations.\(^1\) The authority should also make available to interested persons the processes that are in place for contacting the authority and the expected time it might take to get a response. The openness that is required to meet this standard is consistent with what a supervisory authority would expect a regulated entity to have in place for dealing with its customers.\(^2\) It is essential that companies should have access to all of the text of the legislation, regulations, guidance, and interpretations that define what is required of them. It is also reasonable to provide such information to the general public, should they want to read or refer to it, because the supervisory authority is working on their behalf.

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1. ICP 3 on supervisory authority deals more completely with the legal authority and powers of the supervisor. Transparency, in the context of ICP 4, requires that this information and its interpretation be made available to the public.
2. For more information, refer to ICP 25 on consumer protection and the requirements for an insurer to make information on a range of issues and internal procedures available to its customers.
Paragraph 4.3 indicates that supervisors must be accountable for the actions that they take in carrying out their duties. Since the concept of accountability requires an audience, accountability is to the legislative authority that granted the power to it. In meeting this accountability, the supervisory authority should explain decisions taken. This paragraph does not prescribe how this accountability is to be met; rather it focuses on the need for the authority to explain whatever approach it has adopted.

Paragraph 4.4 describes the general approaches that might be used to provide the accountability described in paragraph 4.3. The disclosure and controls described are consistent with what a supervisor would expect a company to have in place regarding corporate governance and internal control processes.

The essential criteria are specific elements related to the ICP that are used to assess the degree to which a supervisory authority meets the requirements of the core principle. Essential criterion a requires the supervisor to have in place processes that are consistent and clear and to communicate these to interested and affected persons and groups.

Essential criterion b deals with the need for supervisors to be consistent and equitable, while recognizing that some insurers are inherently more risky than others by the nature of their business activities, controls, strategy, or solvency. This criterion allows a supervisor to recognize that these insurers require special attention and a higher level of supervisory activity.

Essential criterion c recognizes that decisions made by the supervisory authority can have a punitive impact (such as a restriction on activities) or a financial impact (such as a cost to bring the operation into compliance or a monetary fine) on the regulated insurers and that these insurers may want to challenge the authority’s decision to impose a sanction or a special requirement on them. This criterion requires supervisors to have sufficient powers to enforce decisions in the event that they are challenged. This could require that the decision be subject to review prior to communication or be open to challenge through the courts after it has been communicated.

Essential criterion d requires the supervisory authority to make public its role and duties. This is necessary so that consumers can understand the function of the authority in protecting their interests and so that insurers can understand how the authority might deal with them.

Essential criterion e links to ICP 3 on supervisory authority and ICP 15 on enforcement and sanctions in terms of the powers that supervisors must have to take prompt action to protect the interests of policyholders. This is particularly true in crisis or emergency situations, where prompt action can limit the possible losses to policyholders and claimants and where delay could increase both the risk and the magnitude of losses.

Essential criterion f requires that the process available for appealing enforcement decisions be made known to insurers and requires the authority to be fair and balanced in its deliberations.

Essential criterion g requires the supervisory authority to prepare and release a report, at least annually, on its activities and decisions and to demonstrate how these
activities and decisions link to its duties and role. These reports are an important element of explaining to the public what the authority is supposed to achieve and how its activities have worked toward those objectives over the period. In this way, the public can better understand the role and work of the authority as well as hold the authority accountable for meeting its goal.

There is one advanced criterion in ICP 4, and this deals with the practice in many jurisdictions of having the supervisor prepare and release a report on the insurance industry, recent trends that have been observed, and changes in the market that have a material impact on the industry. This information may form part of the annual report of the supervisory authority, and it may be supported by data from the regulatory reports filed by each insurer. The supporting data may be published or made available on request (with or without a fee for providing that information). These data releases allow interested individuals and groups to analyze the results of the industry, a group of companies, or an individual company so they are able to make their own assessments and, perhaps, provide independent commentary to their clients or the public at-large.

Exercises
For each of the following questions, which responses are correct? Circle your choices. Note that more than one answer may be valid.

1. ICP 4 requires each supervisor to adopt clear supervisory processes so that:
   a. The staff of the supervisory authority understand their role
   b. The insurers understand how the industry is supervised
   c. The general public can see how the work is done
   d. The government can hold the supervisor responsible for the work
   e. The supervisory approach can anticipate when a failure will occur.

2. ICP 4 requires each supervisor to:
   a. Be transparent in how it carries out its work
   b. Apply enforcement actions that reflect the risk profile of the insurer
   c. Ask the insurers for advice on how to carry out effective supervision
   d. Publish the insurance regulations in booklet form for ease of handling
   e. Make decisions even though they may be appealed.

3. ICP 4 requires supervisory processes to be applied in a consistent manner. This means that:
   a. The same penalty is applied to all for the same offence
   b. Penalties of similar impact are applied for offences of similar importance
c. The sanction should reflect the risks to the insurance sector
d. The speed with which a remedy is expected will always be the same
e. The decision to impose a sanction will be made at the most senior levels in the supervisory authority.

4. **ICP 4 requires that decisionmaking lines be structured because:**
   a. The staff need to understand the limit of their decisionmaking authority
   b. Doing so minimizes the potential for appeals to be successful
   c. The insurers need to understand how decisions are made and by whom
   d. The insurers need to understand to whom an appeal can be made
   e. Insurers need to understand how they can get special treatment.

5. **The supervisory authority must be accountable for its actions because:**
   a. With power come responsibility and accountability
   b. It is in the best interest of the public to do so
   c. It keeps the supervisor honest
   d. Building public confidence is not an easy job
   e. The banking supervisor needs to understand the impact of insurers on the viability of banks.

6. **ICP 4 requires that decisions made by the supervisor could be subjected to a judicial review:**
   a. Because supervisors should be aware that they could be sued
   b. But the decision made by the supervisor should still be applied
   c. But this should not impede the supervisor from making a timely intervention
   d. And these reviews could extend over several years
   e. And such review should allow insurers to continue to operate normally.
B. Supervisory mandate

The supervisory process is tightly linked to the enabling legislation, mandate, accountability, and organization of the supervisory authority. Each is dependent on the other, and, as one changes, it can affect the other. This module briefly discusses the mandate and organization of the authority, focuses on the supervisory process and the accountability of the supervisory authority, and discusses indirectly the legislative authority of the supervisor.

The supervisory mandate should be a clear written statement of the role and responsibilities of the supervisory authority. It is also important for the supervisor to have a clear definition of the range of decisionmaking and enforcement authority for which it is accountable. These two duties are tightly linked in providing a basis for effective insurance supervision. One basically describes the job, and the other describes the decisionmaking authority that is given to the supervisor to carry out that responsibility. Without a clear written statement setting out the duties and responsibilities of the supervisory authority, it will be difficult to assess whether performance has met expectations. In the absence of a clear description of what is required, critics of the work of the supervisor will assess the performance of the supervisory authority against their own expectations, which can leave the authority in a weak position to explain its work.

The mandate may be worded in a manner that is hard to measure such as “maintain public confidence in the insurance sector” or “protect the interests of policyholders,” whereas it is common for the accountabilities to be quite specific, such as “responsible for the enforcement of the Insurance Companies Act” or “has the authority granted to the supervisor defined in the Insurance Act.”

Whether the wording is general or specific, the supervisor's duties, responsibilities, and authority are contained in these brief statements and the legislation that is linked directly to them. These statements constitute an important foundation for the work of the supervisory authority.

Since the mandates of the insurance, banking, and securities authorities may all refer to common goals, it is important for the authorities within a jurisdiction to work cooperatively. This is necessary because each of these regulatory and supervisory bodies should, whether explicitly required or not, “contribute to public confidence in the financial system.” None of these bodies has complete control of the elements of the financial system or the ability to achieve that goal on its own. Only by coordinating their efforts and working with the central bank can the goal be truly achieved.

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3. This power is defined in the insurance legislation and in the legislation, if any, that establishes the insurance supervisory authority. This topic is discussed in more detail in the module dealing with ICP 2 on supervisory objectives.
C. Supervisory methodology

This section discusses the structure of the supervisory authority and the approaches to supervision.

**Structure of the supervisory authority**

The insurance supervisory authority may be part of a government department, a separate agency of government, or part of the central bank. The insurance supervisor may be separate from other supervisors and regulators or be part of the same department or agency as the banking supervisor or securities regulator.

In some jurisdictions, the full range of supervisory powers does not rest with a single authority. Rather, the work is distributed among various bodies. This affects the mandate, organization, powers, and staffing of the authorities and their need to work cooperatively. For the purpose of this module, we restrict the discussion to supervisory authorities that enjoy the full scope of the powers and duties covered by the ICPs.

Independent of whether the supervisory authority is a department within the government or an agency of government, the structure of the authority itself is usually affected by its functions and the work flows needed to perform these functions. The work flows could lead to separate areas within the authority that deal with the following:

- Licensing, offsite analysis, and onsite inspection and the technical aspects of supervision
- Regulation or policymaking versus supervisory work
- Prudential supervisory issues versus market conduct issues
- “Back office” work of the supervisory authority, such as technology, records, human resources, and controls versus offsite and onsite inspection work.

The supervisory authority could be an integrated one that deals with banking and insurance, which could affect both the supervisory methodology and the manner in which the authority is organized. It could affect the number of experienced staff and the range of skills that are needed within the authority to support effective supervision.

So the organization of the supervisory authority is itself linked with the mandate and accountability because these two statements define the scope of the work to be done.

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4. For example, in Australia, responsibility for the prudential aspects of supervision rests with the Australian Prudential Regulation Authority (APRA), while supervision of market conduct issues falls to the Australian Securities and Investment Commission (ASIC). In some jurisdictions, licensing of insurers falls to one department of government, while the other elements of supervision fall to the insurance supervisory authority.

5. An agency responsible for supervising any combination of banking, insurance, and securities is often referred to as an integrated supervisory authority. There are many examples of integrated supervisors. For example, the Financial Services Authority in the United Kingdom and the Monetary Authority of Singapore have responsibility for market conduct and prudential supervision in banking, insurance, and securities; the Office of the Superintendent of Financial Institutions in Canada has responsibility for the prudential supervision of banking and insurance; and the Financial Services Board in South Africa has responsibility for market conduct and prudential supervision of insurance and securities.
done, the powers available to meet those duties, and some of the skills required of the staff.

However, the organization of the supervisory authority should support the supervisory practices and procedures. By that, we mean that the supervisory processes should define the information needs, the use of that information, the number and quality of staff, and their interaction. No matter what structure is established, the staff need to work together in a coordinated manner, share the same objectives, and be organized in a manner that can be understood by the individuals, groups, and companies affected by the supervisory authority.

Within the authority, the staff could be organized by function (analysis, onsite inspection, licensing, and so forth) or into multidisciplinary teams, each of which is assigned one or a group of companies to supervise. Independent of the organizational structure within the authority, the nature of the tasks to be performed is similar.

Not only is it important for the staff to understand the work flows within the supervisory authority, but also the public must have access to and be able to understand how to deal with the authority when it is necessary for them to do so.

Individual consumers who have a question about the industry, or a complaint, must be able to deal with the authority. Insurers and potential owners of insurance enterprises must have access to information that tells them who to contact within the authority in making applications, asking questions, filing information, or otherwise dealing with the supervisory authority.

Making this information public can be achieved in various ways, such as:

- Including a section in the annual report that sets out the structure and organization of the supervisory authority
- Putting the information on the website that the authority maintains
- Preparing material for the public that deals with commonly asked questions
- Giving a group within the supervisory authority responsibility for communication, both proactive and responsive to the needs of the public.

Whatever method, or combination of methods, is chosen for releasing this information to the public, it will be useful so long as the majority of people who should have access to the information can get it with little inconvenience and at a reasonable cost.

**Tasks of supervision**

Each supervisory approach includes essentially the same basic tasks (see figure 1). The details of how they are done and the skills required to perform them vary with the methodology used. In fact, the basic work flow involved in prudential supervision is similar to that involved in assessing market conduct activities of an insurer, even though the types of information and the range of issues to be considered are quite different.
Figure 1 illustrates the numerous activities that have to be carried out in order to assess any one insurer. Although once started, the process can be continuous, it starts with the receipt of financial and nonfinancial information that each company is required to submit at least annually. This is shown in the top left-hand corner of the figure. This information is described in ICP 12 and could include a comprehensive report on the financial condition of the insurer and its business activities, the composition of its board, and the business plan for the upcoming year.

This information is subjected to a comprehensive review by the staff of the supervisory authority to:

- Verify its accuracy to the extent that this can be done by comparing information (a) in one part of the return with information in other parts and (b) in the current return with past returns from the insurer
- Identify trends by comparing information in the current return with information in a series of prior returns from the insurer
• Compare the results achieved by one company with those reported by other companies with similar operating characteristics.

The techniques used in this offsite review include trend analysis, peer group analysis, tests for compliance with minimum standards, ratio analysis, and risk analysis. The results of this offsite work, together with information on the sector or economy generally, plus information from analysis and inspection work from prior years, help to identify the areas that need further examination during an onsite inspection.

Following the onsite inspection, the supervisory authority prepares a letter to the company outlining its findings and describing any remedial action that must be taken by the company. This forms an important part of the information that is tracked by the supervisor during the year as the progress to implementing remediation is monitored.

This cycle of activities is repeated each year and more frequently if the supervisor has significant concern about the viability of the insurer.

The activities that the staff of the supervisory authority carry out are necessary for the authority to meet its mandate. Both the mandate and the supervisory process must recognize the stage of development of the market, the quality and skills of the people available to the industry and the supervisory authority to carry out the work, and the complexity of the business undertaken by the market players.

As we have already seen, this process includes how the supervisory authority is structured, staffed, and organized and how work flows between areas within the organization. It covers market conduct and prudential aspects of the authority’s work. The supervisory process also covers how companies are allowed to enter the market and how they must exit it. In general, these processes provide stability, predictability, consistency, and even-handedness through the use of transparent and competently applied work discipline.

Supervisory processes must reflect the stage of development of the industry, the availability of sufficient qualified and knowledgeable people to support the industry and the supervisory authority, the soundness of corporate governance standards in the jurisdiction, and the relationship of the insurance sector to other elements of the financial services sector. The processes must be flexible enough to allow the analysts to initiate an in-depth review should new information indicate a potential supervisory concern. In other words, even though the supervisory processes should include a structured, disciplined review, the process should not be so rigid that it is difficult to incorporate new information and ensure that the process is efficient.

In general, in the early stage of insurance market development, the supervisory authority may be more likely to establish comprehensive rules with which insurers must comply, including premium rates, provisioning, and policy terms and conditions. This type of regime is well suited to a compliance assessment supervisory approach (see figure 2). As the market grows and the level of expertise within each company and within

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6. For more information about the role of onsite inspection, refer to the IAIS (1998). This standard sets out the objective of onsite inspection, the onsite inspection procedure, and the organization of the onsite inspection process.
the supervisory authority increases, more discretion may be built into the system, enabling companies to apply their judgment and experience in most areas.

With more freedom of action and decisionmaking comes more responsibility. And so it follows that, as the market develops, the authority can be less prescriptive and will look more and more to the company for robust risk management, internal control, and compliance monitoring procedures. This encourages innovation and competition. However, during the transition period, it is important for the authority to be vigilant for increases in the level of risk accepted by companies without proper risk management processes.

This transition of supervisory approach and market development happens in all markets, and so supervisory processes are constantly under review, assessment, and revision. In many aspects of the authority’s role, the supervisory processes follow the development of new products and services. In other areas, changes in supervisory processes lead to changes in the insurance markets, as they are made more liberal and competitive. This leads to the constant change in supervisory practices that is seen in many markets.

Figure 2 illustrates the range of supervisory approaches that might be adopted and how they interact. The illustration does not capture every possible supervisory method, but it does pick up the basic concepts that are incorporated in most methodologies.

As one moves from left to right, greater emphasis is placed on risk-focused approaches and less on compliance assessment approaches. This change in emphasis is needed in order to keep the supervisory methodology as efficient as possible, while ensuring that the human resource skills and experience are used as effectively as possible.
For any one jurisdiction, the actual point that is selected along this continuum will depend on the stage of development of the industry, the mandate of the supervisory authority, the skills and experience of people within the industry and within the supervisory authority, the business culture, and the political reality.

Exercises

For each of the following questions, which responses are correct? Circle your choices. More than one may be valid.

7. Supervisors should have a mandate because:
   a. The supervisor can better understand the job
   b. Supervisory performance can be assessed against a preset goal
   c. It is clear what the legislative branch is expecting
   d. The insurance core principles require the supervisor to have a mandate
   e. It gives the supervisor a reason for not making decisions that fall outside the mandate.

8. How a supervisory authority is organized is important because:
   a. There is a global trend toward integrated supervisory authorities
   b. The structure should satisfy the needs of the staff
   c. The structure should be understood by the insurers
   d. The public needs to understand how to deal with the supervisor
   e. The structure must be described frequently.

9. It is important for supervisors to make public the structure of the supervisory authority so that:
   a. The public can understand how to deal with the supervisory authority
   b. The authority is not seen as secretive
   c. Potential insurers know where to apply for a license
   d. The staff can talk about the office in public
   e. Politicians know who to talk to about an issue involving an insurer.
Exercises (continued)

10. The supervisory process can involve several approaches, including:
   a. Assuring that companies are in compliance with the law
   b. Focusing on critical risks in the industry
   c. Focusing inspection on the internal processes that companies use
   d. Auditing the financial information for accuracy
   e. Counting the bonds in the insurer’s vault.

11. A supervisory process includes the following elements:
   a. Collecting information
   b. Analyzing information
   c. Filing information for later use
   d. Talking to management in an insurer’s office about its business plan
   e. Talking to the rating agencies about the companies in the market.

12. It is important to match the stage of development of the insurance sector with the supervisory processes used because:
   a. Using the staff effectively is important
   b. The most advanced systems in the world require the most qualified people
   c. To be effective supervisors must be realistic
   d. The industry has to be able to understand what is expected of them
   e. The insurer’s board of directors must be competent and willing to work.

13. Having adopted a supervisory process, the supervisory authority should:
   a. Make its approach known to the public
   b. Be prepared to change it again
   c. Encourage onsite inspectors to talk about it with the insurers
   d. Always be prepared to wind up an insolvent insurer
   e. Establish a contingency plan to deal with a natural disaster.

Supervisory approaches

The supervisory practices that are in use fall into two broad categories, as shown in figure 2, and each is important. It is expected that every supervisory authority would use a combination of these methods and not rely on one to the exclusion of the other.
Figure 2 identifies three basic supervisory approaches on which supervisory processes are designed. These are compliance assessment, internal process assessment, and risk-focused approaches. The weight given to each of these in a particular jurisdiction will define the actual supervisory process that is in place within the supervisory authority.

### Compliance Assessment

The compliance assessment approach focuses on the processes that insurers have in place and the degree to which they comply with the legislation, regulations, guidelines, and procedural requirements set by the supervisory authority (this includes prudential requirements, market conduct requirements, and anti-money laundering protection, among other things). A heavy weighting of this approach is appropriate in a market that is in an early stage of development or in which companies have prescribed rules to comply with and are given little discretion for independent investment, pricing, provisioning, or financial reporting.7

Compliance assessment can be carried out by people who are trained to look at the company’s processes and the results of these processes to determine if what the company is doing is consistent with the rules. The result in respect of any one requirement is either a “yes” or “no” rating since a company is either in compliance or not. The supervisory assessment would consider most, if not all, areas of the legislation and regulations prescribed within the jurisdiction.

This methodology often results in a “checklist” of important areas in which compliance is assessed and rated. Violations are noted, and the insurer is directed to take corrective action to bring the company into compliance.

The strength of the compliance assessment approach includes the following:

- It is easy for both the supervisor and the regulated entities to understand.
- The supervisor can point to a specific provision in the legislation or regulations in the event of noncompliance.
- The inspectors can be trained to identify compliance using the specific examples, having clear procedures for verifying compliance, and having clear actions to be taken if noncompliance is discovered.

The weaknesses of this approach include the following:

- Even if a company is in compliance with all of the rules and regulations, it could be involved in a business activity that exceeds its risk tolerance, and this approach might not uncover that situation.

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7. The term “provisioning” refers to the techniques used by companies to value the future policy benefits or unpaid benefits, whether these are for policies that still pay premiums or not. This covers the value of due and unpaid claims, incurred but unreported claims, and policy liabilities of any sort. This calculation is often performed by an actuary but, under certain circumstances, may be carried out by management to standards prescribed by the supervisory authority.
• This “one rule fits all” approach assumes that compliance leads to well-run companies and financial soundness, and this may be a false premise.
• The approach tends to conclude simply that a company either is in compliance with the rules and regulations or is not.
• This approach can result in the staff of the supervisory authority and the external auditor doing many of the same checks, which could create inefficiencies in the supervisory process and raise the costs to the insurers.

**Risk-focused supervision**

The other broad category is generally referred to as risk-focused (or risk-based) supervision. This category includes a wide range of practices that focus on the risks in the industry and individual companies and how the insurers manage those risks. Any methodology that includes a risk review is usually referred to as risk focused.

However, as can be seen in figure 2, supervisory processes that are closer to the left-hand end of the range might carry out cross-sector studies on the risks and risk management practices of insurers in certain high-risk areas of the business, while focusing the major part of their inspection effort on compliance, verification, or audit processes. At the left-hand end of the range, the authority carries out onsite inspections in which the inspectors (officers or examiners) look at the degree of compliance that companies have with particular rules and regulations, including verification of the accuracy and completeness of the financial reports filed with the authority, while at the same time carrying out a cross-sector study of risk management practices.

A cross-sector study is a useful technique for looking at specific risks or concentrations within the industry (see figure 3). The results assist the authority in determining industry norms, exposures, and practices. The results are useful to the insurers because companies receive feedback on where they stand in relation to the rest of the industry (companies are told where their results fall in relation to the industry, but they are not told the results of any other company). Insurers may not be able to get reliable information on these topics unless the supervisory authority conducts a cross-sector study.

![Figure 3. Cross-sector study](image)

8. Figure 3 illustrates the steps that are often included in a cross-sector study (that is, a study of risks or risk management control procedures that companies have in place). Initially, supervisors carry out industry-wide studies on areas such as concentration risks (exposure to certain types of risky assets or certain classes of insurance, perhaps) and then, with experience, move on to studies that look at company practices in managing and controlling certain risk exposures (such as the processes for establishing internal retention limits and the limits placed on the types and concentration of reinsurance programs).
At the right-hand end of the risk-focused approach (see figure 4), the supervisory authority focuses on the internal controls within an insurer’s operation, including the insurer’s compliance management process, and looks in detail only at aspects of the insurer’s operation that have a concentration of high-risk activities. This approach often places a heavier reliance on the work of others, including auditors, boards of directors, professionals within the company, and professionals who advise the company. As a result, the supervisory process also considers the work of these professionals to determine the extent to which their work can be used and how dependable it is. Where the work is not performed to a satisfactory standard, the supervisor works with the profession, board, or other groups to strengthen the standards and make their application more effective. So, at the right-hand end of the range, the supervisor focuses on the processes used by the company to measure, manage, and control risks and does not spend much time auditing or verifying the results submitted.

These multiple layers of dependence and reliance are intended to remove duplication and inefficiency, but they do mean that the authority needs to have the power and the competence to review the work of people who may not be directly covered by the insurance legislation and to have confidence in the adequacy of the standards to which they do their work.

Under the risk-focused approach, the analysis considers economic, industry, and company-specific information to identify areas of potential vulnerability in an insurer. These are referred to as significant activities and could be a line of business, a geographic area of operation, a department or area of operation in the company, or an aspect of the business that may be inherently risky. During this stage, the supervisor forms a view of the gross risk exposure and its significance to the insurer. At the risk of oversimplification, the supervisor looks for areas of the business that, in the absence of risk management, are unpredictable, statistically unstable, and unaffordable—that is, areas of the business that can have a significant impact on the profitability of the insurer.

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9. Compliance has two different meanings between the extremes in this spectrum of supervisory practices. At the compliance assessment end, it refers to compliance with the law and regulations over which the insurance supervisor has authority. At the “full” risk-focused end, it refers to compliance with all of the laws and regulations with which the insurer must comply, including the insurer’s internal rules. This change is implemented as the methodology moves from compliance assessment toward risk-focused assessment at the point that the supervisor requires all insurers to implement an internal compliance management system. For example, even though the supervisor has no direct power to enforce employment law, an insurer must have a control process in place to ensure that its activities are in compliance. Noncompliance with any of these other laws could present risks to the continued ability of the insurer to operate. So, the compliance management system in a risk-focused model must cover all legislation and regulations, and the insurance supervisor must have sufficient power to review these control procedures as well as those that have a direct effect on compliance with insurance legislation.
The inspection plan would include the most important areas of risk identified in the analysis. The reason that all areas of significant risk are not considered at once is simply the practical issue of finding the resources (financial, time, and human) to carry out a detailed inspection of a large number of areas within each insurer and to do so in a short period of time.

During the onsite inspection, the supervisory authority would examine what the insurer does to manage or control the risks within the significant activities being examined. Risk management activities are often referred to as mitigants. These are activities that transform the risks from ones that are unpredictable, unstable, or unaffordable into business outcomes that are predictable, stable, and affordable. These risk management activities could cover a wide range, including:

- Sound underwriting practices
- Appropriate concentration limits for both assets and liabilities
- The effective use of reinsurance
- Sound internal controls
- Strong corporate governance culture
- Sound human resource policies
- Robust compliance management systems
- Sound investment management controls
- Appropriate claims adjudication practices.

In fact, almost any action that makes the financial results for a business activity more predictable and affordable could be considered a risk mitigation activity.

The supervisor has to apply a great deal of judgment in assessing these practices because there could be significant differences among practices in different companies, and practices that work in one company may not be effective in another. During this part of the risk-focused approach, the supervisor also judges the effectiveness of these practices in making the results within the activity stable, predictable, and affordable.

Where the risk management activities are determined to be less than adequate, the supervisor must determine what action the insurer should take to remedy the situation, and this will form part of the management letter requiring remedial action.

By its very nature, this approach can lead the supervisor into an in-depth inspection of aspects of the insurers’ business that might fall outside strict interpretation of the legislation and regulations in the jurisdiction. For the risk-focused approach to be effective, the supervisor must have the power to carry out in-depth inspections in any area of risk that is felt to be significant and be able to enforce remedial action by the company if the authority determines that this is appropriate.

The strengths of the risk-focused approach include the following:

- It focuses supervisory attention on the areas of each company’s operation that are most important to its continued viability and financial soundness.
Since each company is different, this approach “customizes” the review process to the unique characteristics of each company and, as such, can assist the supervisor in identifying potential problems early.

This approach is built on the premise that insurers are in the business of mitigating their customers’ risks, so they should likewise be expected to manage their own risks well, and the supervisory approach should mirror the manner in which companies manage their affairs.

The process usually produces an overall rating of an insurer, such as “strong, acceptable, or weak” or perhaps four categories, such as “strong, medium strong, medium weak, and weak.”

The risk-focused approach is forward looking—that is, it tries to anticipate future problems.

The weaknesses of the risk-focused approach include the following:

- It requires the supervisor to apply discretionary judgment, which requires skill and confidence on the part of the staff of the supervisory authority.
- It focuses attention on the most critical areas of each company’s operation, and the potential downfall of the company could come from what the analyst considers a minor area or insignificant activity.
- In many markets, it is difficult to recruit and train supervisory staff with the skills and experience needed to be truly effective risk-focused supervisors.

**Process Assessment**

The process assessment approach focuses the authority’s attention on the internal control procedures that companies use to manage their business. This approach is built on the premise that companies should have robust internal control procedures in order to know what is happening in the company and be confident that the work is being done to the standards set by management and the board.

While a review of the procedures often includes a review of a sample of the results achieved, the inspectors are looking to see that the company’s policy is known and applied and that the results are reported upward within the management of the insurer. When errors are found or polices are not being followed, the supervisory authority focuses its demand for corrective action on the process and the management of that process and to a lesser extent on the error that may have emerged as a result.

This supervisory approach is a precondition to implementing an advanced version of the risk-focused approach. Figure 2 illustrates the process assessment approach as a part of the risk-focused approach since it is a necessary tool for implementing more advanced risk-focused techniques. However, process assessment can be an effective part
of a supervisory approach that is more closely aligned to compliance assessment, so it can be considered as a separate approach on its own merit.

The strengths of this approach include the following:

- It builds on the processes that well-run insurers should have in place to manage their affairs.
- Boards of directors and senior management need to have processes in place to ensure that the staff carry out their directives, and they do this by having internal controls on the processes they use.
- It reviews the soundness of these processes to be sure they work.

The weaknesses of the process-focused approach include the following:

- There can be significant differences between the practices of different insurers, so judgment is required in assessing whether the practices are appropriate to each insurer’s situation.
- The inspection team must focus its attention on whether the process that an insurer has in place actually works, not on whether it is the same as ones used by other insurers.
- It requires inspectors to have knowledge of sound general management practices, and that knowledge may be lacking in the supervisory authority.

**Rating systems**

Structured supervisory processes, with the possible exception of the compliance assessment approach, usually result in a rating being assigned to each company by the supervisory authority. The rating may or may not be disclosed to the company, depending on conditions in the local market. However, this rating is a powerful supervisory tool when it is clearly disclosed to the company because it conveys the level of supervisory concern regarding the conclusions and recommendations made to the company.

In a compliance assessment approach, the rating could indicate that the insurer is in compliance, substantially in compliance, or not in compliance. However, under a risk-focused approach, the rating system could have more separation to distinguish between insurers that are becoming stronger and those that are becoming weaker.

Since the systems that supervisors use for determining and assigning supervisory ratings form part of the modules dealing with ongoing supervision (ICPs 11 through 17), we do not go into these systems here, other than to say that they are an important element of an effective supervisory process.
Each of the supervisory approaches discussed in this module has advantages and disadvantages. None is perfect and capable of meeting supervisory needs in all circumstances. The most appropriate methodology for a jurisdiction is one that combines these approaches in a way that recognizes the nature of the insurance business in that market, the availability of experienced and able people to meet the needs of the industry and the supervisory authority, the availability of capable people to serve as members of boards of directors under a robust corporate governance regime, the supervisory mandate, the independence of the supervisory authority, and the strength and discipline of professionals needed to support the insurance sector.\textsuperscript{10}

The advantage of using a variation of the risk-focused approach is that it focuses supervisory attention on the critical factors that are likely to determine the level of future success of the insurer. Insurance is a risk management business and the better that these risks are managed the greater the likelihood that the enterprise will be profitable and a financial success. By focusing on these critical factors of success, the supervisory authority is more likely to identify problems at an early stage and require the company to take remedial action before the problem gets out of control. Supervisory approaches that are built on the approaches that insurers use to manage the business have the greatest chance of being understood by management. Using inspection processes that focus on the same issues as management deals with on a day-to-day basis can resolve problems quickly because they are more likely to be understood and accepted.

The advantage of using an element of the compliance assessment approach is that it recognizes, and shows to the industry, that compliance is important for running a successful insurance operation that benefits policyholders and claimants over an extended period of time and that the supervisory authority believes that complying with the rules is important for all insurers. Unless the supervisor is truly confident that an insurer is adequately fulfilling its responsibility to manage and control the compliance assessment process, the supervisor must demonstrate the importance of this activity by inspecting it.\textsuperscript{11}

The advantage of the process assessment approach is that it builds inspection around what should be in place in a well-run insurance operation. Encouraging sound internal controls and robust risk measurement and management practices can strengthen the industry and make it more resilient. Building on best practices as a framework for insurance supervision can benefit all parties.

Developing a supervisory methodology for a jurisdiction that takes the advantages and minimizes the disadvantages of each approach would identify the point on the continuum shown in figure 2 that best meets the needs of a jurisdiction.

\textsuperscript{10} Independence in this context refers to the ability of the authority to act under the terms of the legislation without undue influence or interference from the industry, from other departments or arms of the government, or from elected officials. Where that interference affects the ability of the authority to make timely and effective decisions, the application of enforcement actions based on the judgment of the inspection team can be compromised.

\textsuperscript{11} If a law is worth writing, it must be capable of being enforced and be worth inspecting and enforcing.
DEALING WITH ADMINISTRATIVE MATTERS

The processes that a supervisory authority uses to perform its duties beyond the analysis and inspection of insurers must be consistent with the analysis and inspection functions. An obvious example is the need for licensing and changes in control procedures to apply the same standards as will apply as soon as the insurer becomes licensed. The newly licensed entity should be one that can be supervised. In other words, the corporate structure should not be so complex that it is difficult to understand, the structure should facilitate consolidated supervision, and the quality of work that is required from an applicant should be consistent with what will be expected once the license is granted. Business plans, strategies, composition and structure of the board, knowledge of the business and the local market, and control culture are required in one way or another for all insurers, regardless of the supervisory methodology used. However, whether the authority is using compliance assessment or a variation of risk-focused approach will determine the degree of emphasis placed on the company to have robust procedures in each of these areas.

Each of these issues should be dealt with during the licensing stage, and, if necessary, revisions should be made in advance of licensing. The authority should not be placed in the position of having to require the insurer or the group to which it belongs to make changes in its structure, risk management practices, or organization immediately after it has been licensed. For example, ICP 17 on group-wide supervision requires insurance supervisors to carry out both solo and group-wide supervision. For this requirement to be met, the supervisor of the most “senior” insurance company in the group must be able to form an opinion on the strength of the insurance operations of the group as a whole. The intent of this provision cannot easily be met if banking and insurance operations are mixed or if the group commingles financial services and manufacturing. The issue of the “supervisability” of the insurer and the group provides clarity of organization and reduces the potential for regulatory arbitrage and inter-company contagion within the group.

Even filing systems maintained by the supervisory authority on each insurer might change as the supervisory methodology changes. Under a compliance assessment approach, the supervisory filing system might have a unique file for each insurer each year. In deciding on the inspection focus in subsequent years, the files from previous years are referred to so that conclusions, enforcement decisions, and remedial actions can be followed up.

Under a risk-focused approach, files should be organized by insurer and significant activity or area of risk. The files from prior years thus form part of the current files and are updated to reflect any significant changes in people or processes. These files are not replaced or completely rewritten unless the changes are so substantial that they require a new in-depth investigation by the analysts and onsite inspectors.
Many supervisory authorities have set and published performance standards with which staff of the supervisory authority are expected to comply. These include the time within which it can be expected to respond to a request, deal with a complaint, acknowledge receipt of a letter, process an application, and so forth. It is understood that these are guidelines for the expected time it takes to deal with a “standard” case. Situations that require more time to complete are acknowledged, and the party is informed of the date by which to expect a response.

Whatever the administrative and internal control processes, the supervisory authority should make available to the public a statement of the processes and requirements of the supervisory authority. These statements could be in the form of administrative notes, guidance, or simply procedural notes that are available on request or posted on the supervisory authority’s website.

**Dealings with crises**

In the same manner that insurers are expected to have a business continuity plan for dealing with events that could cause business interruptions, it is good practice for supervisory authorities to have a crisis management plan for dealing with any future crisis. For a more in-depth discussion of this topic, refer to the module on ICP 16 on winding up and exit from the market.

All supervisory approaches require skilled and able people to make them work. The numbers and level of the staff assigned to review a company depend on the scope and complexity of its business, the level of concern that the authority has with the operations of the insurer, the responsiveness of the insurer to take corrective action when asked to do so by the supervisory authority, and the quality of the insurer’s internal control processes.

In planning for and dealing with a crisis, it is important for the supervisor to distinguish between the failure of a company and the failure of the supervisory process. The supervisory process fails if the supervisor is surprised by the failure of a company or fails to take timely action when problems arise. A company fails when and if it ceases to be viable. Supervisors should have robust supervisory processes to ensure that their internal systems do not fail, and they should plan for crises that could arise from the failure of a company or group of companies.

When a crisis occurs with an insurer, demands are placed on the staff within the supervisory authority. It is common for the team assigned to deal with these situations to come from the team that normally carries out the analysis and onsite inspection of the insurer, augmented by other staff with experience in dealing with troubled companies. This causes a reassignment of members of the staff, and this, in turn, affects the work that can be performed in other areas and with other companies.

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12. For an example of how this has been done, refer to the website of the Office of the Superintendent of Financial Institutions, Canada (OSFI) and follow the links to Reports/Departmental Performance Reports. The website is at www.osfi-bsif.gc.ca.
As a result, all supervisory approaches or methodologies need to have built-in mechanisms to reassign staff members to deal with crises as they occur and to reduce the work that will be done on elements of the sector that are not significantly affected by the crisis.

This priority-setting process can be aided by having a supervisory rating system in place that assigns a rating for each company depending on the degree of concern that the supervisor has for the entity. In a crisis, if experienced staff are working on insurers that are considered to be low risk, they could be reassigned to deal with high-risk entities. At the same time, the scope of the inspection work for low-risk insurers could be narrowed to rebalance the resources available with the total work that needs to be done.

Supervisors should establish procedures that provide early warning indicators of potential crises. These indicators could be both company specific and comparative across different insurers and might include the following:

- The growth in business that is unusually high (especially if that is accompanied by a risky business strategy such as underpricing)
- Earnings or profits that are consistently low and unsustainable
- Entry into new markets in which management may have little experience
- High claims ratios
- Provisioning that grows less quickly than premium revenues
- Continued decline in the ratio of actual to required capital
- A move to more aggressive accounting or actuarial standards.

Early warning signals can also affect the insurance industry generally. These could include the following:

- An increase in interest rates close to or above minimum guarantees in products
- Increased unemployment
- Unexpected adverse court decisions affecting claims liabilities
- Decline in the value of assets in a geographic area or type of asset in which insurers generally have significant investments.

Independent of the supervisory approach that an authority may select, it is advisable to have in place a series of time-tested early warning indicators. These facilitate decisions on critical areas within companies and the industry generally that deserve in-depth review in the analysis and onsite inspections.

In a crisis situation, many insurers can be affected because they are involved in similar activities, because they operate in similar market segments, or because they are interconnected in some way.\(^{13}\) Care should be taken in determining which insurers are

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\(^{13}\) In the European Economic Area, many insurers operate in several countries. Should a crisis involve one of these insurers, the supervisory authorities in all of the countries in which the insurer operates will have to work together to find a satisfactory resolution.
potentially affected by similar events and risks to ensure that staff are not reassigned from those that could be affected significantly.

Having reassigned the staff to deal with a crisis, the test of the supervisory methodology is that it operates in a crisis situation. The analysis and onsite inspection should be robust enough to deal with significant shifts in expected experience and with the intensified work effort required in a crisis.

**Supervisory Decisionmaking**

When a member of the supervisory authority identifies a weakness in an insurer’s operation that requires significant remedial action, the decision to require the insurer to take action should be made in a way that obtains the support of senior management within the authority before it is imposed on the insurer. This is not intended to be bureaucratic. Rather it is intended to ensure that the officer making the recommendation is supported so that his or her decisions will not be overturned on a simple appeal to management of the supervisory authority.

An important part of any job involves knowing the range of decisionmaking authority that one has and how one goes about getting decisions made that are beyond one’s own authority. These limits need to be clearly defined in companies and are important for effective and efficient supervision. Knowing the limits of decisionmaking authority is an important part of dealing with crises, because having a clearly defined decisionmaking regime can speed up the decisionmaking process.

In general, the more important the decision, the tougher the sanction and the more contentious the issue, the higher in the supervisory authority one should go to obtain support for action.

These processes should form part of the supervisory approach so that all members of staff know and understand their decisionmaking authority and how to obtain support for more complex decisions. Only then will the supervisory process work efficiently and effectively in a crisis. Only then can decisions be made quickly and confidently in a crisis.

The ultimate test of a supervisory methodology is how well it works in a crisis. This is like saying that the test of the supervisability of an insurer is how well problems can be identified and resolved in a crisis and how efficiently the legal entity can be wound up if all else fails.

**Appeals**

It is not unusual for a regulated entity to be unhappy about a supervisory decision and to seek a more powerful person to undo the decision that was made. In most jurisdictions, the law defines a process through which insurers can appeal the decision made or
the sanction imposed by the supervisory authority. This is part of what is often referred to as *due process*.

Depending on the local legislation and the importance of the issue, the appeals process could take one of several courses:

- Appeal to the most senior official in the supervisory authority
- Appeal to the minister to whom the supervisory authority reports
- Appeal to an independent tribunal
- Appeal to the courts.

Appeals can have the effect of delaying action. If an issue would place the interests of policyholders at significant risk that they will lose more money with a delay in action, then a process should be included in the law to protect the interests of policyholders while allowing the appeal to continue.

For most issues, an appeal is made simply because the insurer disagrees with the conclusion and does not want a remedial action imposed. In those circumstances, the appeal probably would be to the most senior person in the supervisory authority.

At the other extreme, if an application is made to the court to wind up a company and the company elects to appeal the decision of the court, the consequences to policyholders could be dramatic. In these cases, some countries allow the winding-up to proceed so that policyholder interests are protected; if the appeal is successful, the government pays a financial penalty, since it would be impractical to reestablish the company.

**Exercises**

For each of the following questions, which responses are correct? Circle your choices. More than one may be valid.

14. The compliance assessment approach has the following features:
   a. Uses onsite inspection to look for violations of the law and regulations
   b. Works well in a principles-based jurisdiction
   c. Is easy to understand
   d. Can miss major risk exposures
   e. Looks at risks the way that insurers should manage risk exposure.
15. **The risk-focused approach has the following features:**
   a. Uses onsite inspection to look for violations of the law and regulations
   b. Works well in a principles-based jurisdiction
   c. Can be simple or complex depending on how it is done
   d. Can miss a major issue of noncompliance in an insurer’s operation
   e. Looks at how insurers should manage risk exposure.

16. **The process assessment approach has the following features:**
   a. Places reliance on the board of directors
   b. Places reliance on the insurer’s internal control procedures
   c. Looks at risk in the same way that insurers should manage risk exposure
   d. Can be simple or complex depending on how it is done
   e. Is easy to understand.

17. **A cross-sector study is useful for the following reasons:**
   a. It identifies insurers that are better or worse than average
   b. It provides information that may not be available using any other approach
   c. It allows the supervisor to use industry practices as a supervisory tool
   d. It can be as detailed as the issue justifies
   e. It can produce information that is helpful to insurers.

18. **Risk management includes the following features:**
   a. Identifies potential areas of risk within an insurer’s operation
   b. Measures risk
   c. Understands the risk and how it can be managed
   d.Eliminates the risk
   e. Determines the materiality of the risk.

19. **Reviewing business plans during the analysis phase is useful because:**
   a. It can show whether the insurer is well managed
   b. The plan shows the financial forecast for the insurer
   c. It can show how good the insurer is at planning
   d. It will show any new initiatives that the insurer has planned
   e. It could identify new risks and how the insurer will respond.
20. It is important for supervisors to be prepared to handle crises because:

   a. Crises can occur at any time
   b. Being ready improves the supervisor’s reputation
   c. Readiness leads to prompt action when it is needed most
   d. A good plan diverts criticism to others who might be less ready
   e. It motivates staff to know that they are needed in a crisis.

For each of the situations described below, what supervisory approach would you suggest should be used? Provide reasons for your choice.

21. One of the analysts in your office has come to you to seek advice on an insurer. The financial return that the insurer filed with your office shows a loss for the year in personal motor vehicle insurance and a claims ratio of 95 percent of premium income. Expenses account for 25 percent of premium on top of that. The analyst reports that premiums were set at the average of the rates charged by the insurer’s major competitors, and this produced a 10 percent increase in new policies over the prior year. He is developing the inspection plan. What would you suggest?

22. You are preparing an inspection plan for an insurer that has a local owner and a good capital position. You note, however, that the level of provision for claims incurred but not reported at the current year-end is below the provision held in the prior year, even though the volume of business has increased 15 percent. You have read a newspaper article indicating that the current owner is looking for someone to purchase the company. What would you suggest?

23. You are preparing an inspection plan for an insurer that is an active investor in loans to medium-size businesses. The economy has deteriorated in the past year and yet the value assigned to the loans has risen substantially. What would you suggest?
D. Supervisory reliance on the work of others

Reliance is a term used to describe a relationship of trust and respect for the work done by others. It is not a blind reliance, rather it is reliance based on oversight. This relationship is built on a mutual understanding, by both parties in the relationship, of what is required and how the work should be performed. It is not built on mistrust or suspicion. Neither is it a contest of wills.

This type of relationship is a powerful tool for supervisory authorities because it allows them to place performance expectations on others and thereby use their work as though it had been performed by a member of the supervisory authority’s staff.

Many supervisors place reliance on the work of auditors and actuaries. Since this is not “blind” reliance, it is necessary for the supervisory authority to have in place sufficient procedures to ensure that the reliance is well placed. This does not mean auditing in order to verify the accuracy of the work performed. Rather it means reviewing the working papers to ensure that the work was performed to agreed standards and, if not, requiring the professional to make revisions.

A reliance relationship involves the following elements.

First, before the work is performed,

- Working with the other party to ensure that they understand what is expected, both the scope of the work and the quality to which it is to be performed—for example, external auditors, the accounting standard-setting body, the actuarial standard-setting body, and boards of directors
- Reviewing the procedures, tests, and standards to which they intend to perform the work—for example, reviewing accounting standards for financial reporting of insurers to be sure that they meet supervisory needs or reviewing audit standards to be sure that sampling techniques are adequate for supervisory needs
- Identifying areas within the standards and procedures that should be strengthened.

Second, while the work is being performed,

- Being open for discussion of unusual situations that might require special tests or analysis not foreseen by the normal procedures—for example, reports of unusual accounting practices being employed followed by a question concerning the desired scope of the audit
- Accepting “whistle blowing” and building the concerns that emerge into the inspection program—for example, whistle blowing can come from any source but often emerges when internal work is under review or examination
- Contacting supervisory authorities in other jurisdictions that may have an interest in the insurer to compare the scope of work and linkages between the work being performed by various parties.
Third, after the work has been performed,

- Reviewing the work process to ensure that it was performed to the standards that were agreed and seek follow-up if it was not—for example, supervisors should be able to review the working papers of auditors to minimize duplication (or at least to discuss findings and the evidence) and to review the actuary’s work
- Reviewing the results of the work and discussing any ambiguities or unusual results that might have emerged
- Strengthening the procedures for future work, where indicated.

In addition to the reliance process described above, some insurance supervisors rely on industry and professional organizations to set standards and oversee one or more activities within the sector. These functions are essentially delegated to the professional association or other competent body by law or by the supervisory authority. This type of delegation is often related to market conduct issues, such as agent and broker training and continuing education and licensing of intermediaries. Even though these are delegated activities, the supervisor must manage the relationship the same way it manages any other reliance relationships. That is, these reliance relationships deserve the same level of oversight and control as others, such as accounting standards.

While reliance relationships are possible with a wide range of service providers, several examples can be useful in understanding this concept:

- Supervisors have a reliance relationship with external auditors. The work performed by the auditor is done to standards of practice that the supervisor has agreed to in advance, and the supervisor has the authority to review the work that was performed and to have it revised should it be discovered that the work was not done to the agreed standards. Further, the supervisor can complain to the professional association to which the auditor belongs (or an authority that oversees the work of auditors) if the work was not done to the agreed standards, and the professional association has the authority to investigate the situation and take disciplinary action against a member found to be in violation of the professional standards of practice.
- Supervisors have both a reliance and a delegation relationship with the staff of the supervisory authority. The work performed by the staff is defined and set out in job descriptions, departmental notes, the supervisory methodology, conflict-of-interest policies, and other internal working documents of the authority. All members of the staff have a superior officer to whom they report, and, at least once each year, the superior officer appraises the work of the staff member to ensure that it is done to agreed standards and performance targets. If weaknesses are identified, suitable training is required to remedy any deficiencies. If the individual’s work is unacceptable, the person is reassigned or dismissed.
Reliance and delegation are similar concepts, and yet they differ in at least one important area. Delegation requires a person who delegates to retain responsibility, while allowing another person to actually do the work. Reliance can involve depending on the work of another person without having direct control over the standards to which that work is done and not being directly responsible for the work and yet relying on the quality of the output.

Reliance, like delegation, requires oversight to ensure that the work is performed to satisfactory standards. If not, then depending on the magnitude of the gap between expectation and what is delivered, the standards to which the work is performed could be strengthened or the relationship could be discontinued and a new “service provider” found. This is not unlike the relationship that a boss has with the staff: work expectation is defined, and performance is assessed against those expectations; if performance is weak, training may solve the problem, but if the work remains unsatisfactory, the person is reassigned or dismissed, and a new person is brought in to do the work.
E. Accountability

*Webster’s Collegiate Dictionary* defines the adjective “accountable” as subject to giving an account; answerable; capable of being accounted for; explainable; responsible. Accountability is a noun with a similar meaning, and so it is used in this module to mean being held responsible to someone, being able to explain what one does with that responsibility, and being able to demonstrate how the responsibility has been met.

Insurance supervisors are accountable to the public for meeting the objectives set out in the mandate. Supervisory powers must be demonstrably applied in an even-handed and consistent manner, so that supervisors are seen to use their powers when necessary without being heavy handed.

Accountability requires a demonstration that the responsibility has been met, and the demonstration helps to build confidence in the supervisory authority and the supervisory processes with:

- Legislators (from whom the powers originated)
- The industry (to whom the powers and processes are applied)
- Industry observers (who can observe the results of the authority’s work and better assess criticism that comes from the industry)
- The staff of the supervisory authority (who can better understand their role and where the functions they perform fit into the overall scheme).

The supervisor must recognize that each of these groups with an interest in following the work of the supervisory authority may have very different motivations for seeking information on the results of the supervisor’s work. The legislative branch may be focusing on the public policy interest of having stable, competitive, and efficient markets for financial services plus concern that the powers granted to the supervisory authority are used and not abused.

The fees that insurers often pay to operate in a jurisdiction make them interested in knowing that the supervisory authority is not wasting money doing unnecessary activities, and insurers are also concerned the treatment that they receive from the supervisory authority is even-handed and not unusually harsh or disruptive.

Industry observers, industry groups, and the media are often interested in consumer issues, such as how complaints are handled, and in investor issues, such as the fair and complete disclosure that companies must make to investors. The reports of the supervisory authority help observers to form views about insurers operating in the market because they allow individuals to compare the comments made by companies on market trends with those made by the supervisor on the same topic.

Public accountability can be achieved by releasing reports into the public domain that address these types of need for information, while recognizing that some of the information available to the supervisor is proprietary company information and should be held confidential. This is an area where accountability and transparency overlap.
F. Transparency

“Transparency” is a term that generally means that information should be made public in a way that is easy for interested parties to gain access to and understand, at a reasonable cost. For some interested parties and types of information, there should be no direct cost, with the cost of preparing and distributing such information being considered part of the general cost of running the supervisory authority. For example, the reports filed with the minister or the legislative branch of government normally are provided to those parties—and often to others—free of charge.

Complete in-depth analysis of data or information, including industry statistics by insurer, may be made available to individuals wishing to carry out an analysis of the industry. This type of information could be costly to prepare and deliver, and it would be reasonable to make it available at a cost to the party asking for it, although some supervisory authorities make such information freely available on their websites. It is important that all supervisory authorities have close control of both the data they receive and the information that is produced as a result of working with those data so that proprietary information is held confidential. In determining what should be held confidential, it is common to consult with the industry and agree on the criteria for determining what is to be held confidential and what can be released to the public.

Where some information is provided at a cost to the party asking for it, it is reasonable to expect that a summary would be provided at no cost to interested parties. This performs two functions. First, it can act as marketing material to describe the nature of the information and provide examples. Second, it allows less sophisticated users to understand what is available and how it can be obtained, and that, in itself, meets the needs of many people. Any examples of what the data contain and examples of the results of industry analysis that has already been performed would be useful to many people.

In addition to annual and other periodic reports, supervisory authorities should ensure that the legislation under which they operate is available to the public together with descriptive material on how to deal with the authority on specific issues. For example, a foreign insurer may simply want to know what is required to obtain a license, and it would be reasonable to assume that this is a common request and that a document dealing with that specific issue is available. This may be in the form of a guidance note or a procedure manual that is available to all interested parties. It is common for much of this type of procedural material to be available on the website of the insurance supervisory authority so that it can be accessed by anyone.

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14. In this context, the term “data” refers to the content of the financial and other returns that insurers file with the supervisory authority and the content of reports provided to the authority by industry associations, economists, and others. The term “information” refers to the results of analyzing these data, drawing conclusions, and observing trends and relationships. Therefore, data are unprocessed raw input, and information is processed data.
**Supervisory processes**

Insurance supervisory authorities should make their processes transparent to the public and the insurers that they supervise. This is necessary to build public confidence in the financial system in general and the insurance sector in particular. It also helps people to understand what the supervisory authority does and how interested parties can deal with or communicate with the authority. Open and transparent processes tend to contribute to public confidence since they can help the public to understand what the authority is doing, whereas if that information is not readily accessible, the public could easily become suspicious and think that “strange and secret” activities are occurring behind closed bureaucratic doors.

However, the supervisor must always be aware of the need to keep confidential the proprietary information about insurers and most supervisory conclusions, except, for example, those related to public sanctioning of an insurer.

ICP 26 on information, disclosure, and transparency toward the markets requires insurers to provide fair, complete, and full disclosure of their activities to the public. The need for supervisory authorities to provide full and meaningful disclosure to the public is similarly important. In many areas of supervision, it is reasonable to require supervisors to be subject to the same requirements they impose on regulated entities so that they are seen to be “practicing what they preach.” Transparency and disclosure are areas where the need for information is equally important, whether it relates to insurers or to the supervisory authority.

As discussed, the most common method for releasing a wide range of information is through the annual report of the supervisory authority. A comprehensive annual report would cover the following topics:

- State of the industry
- Issues facing the industry and how these will be addressed
- Statistics on the industry (growth, capitalization, and its “state of health”)
- International events that affect the insurance industry and the impact on local players
- Changes in legislation
- Supervisory processes and changes implemented
- Summary of the supervisory work performed (for example, new licenses issued, onsite inspections completed, number of licenses canceled)
- Staffing and staff training
- Funding of the supervisory authority (source of money and summary costs)
- Summary of the enforcement actions taken and response from the insurers
- Structure and organization of the insurance supervisory authority and its duties and responsibilities.
Transparency of supervisory processes also involves consultation with interested parties when changes are contemplated. Feedback and comments should be considered before implementing change. That does not mean that the industry should design the regulatory regime; rather it means that the input of the parties most directly affected should be considered so that the result is accepted and constitutes a realistic balance between theoretical soundness and practicality.

As an indication of what is considered to be good practice, many supervisory authorities carry out an extensive consultation process with the industry and professional groups that might be directly or indirectly affected by a change in regulation or supervisory process. Consultation could involve sending the draft material to the interested parties for input and comment, considering each submission, responding to the points made, indicating what the determination was and how the comment was reflected in the revised document, if at all (and explaining why certain comments were not accepted), and repeating the process until a reasonable balance between the objectives of the supervisory authority and what is practical for the industry has been reached.

Industry and company information

ICP 26 on information, disclosure, and transparency toward the market sets out the range of disclosure requirements that supervisors should impose on insurers. The goal of this disclosure is to maintain fair and efficient markets, both for investors and policyholders. The public in general should have confidence in the insurance industry and be reasonably comfortable in the knowledge that companies in the market will be able to pay claims as they fall due. The requirements on insurers should be at least as open and complete as the disclosure requirement imposed on the supervisory authority. After all, the supervisory authority acts on behalf of the public in overseeing the industry, and individual insurers make promises to the public. The higher standard of care should fall to the industry.
G. Consistency

Supervisors must apply their methodology in a fair and even-handed manner. The processes that supervisors use to identify issues should be consistent. There should be internal procedures within the supervisory authority to ensure that a reasonable level of consistency is achieved. The process used to assess the quality and consistency of the application of internal processes is often referred to as a quality assurance process. This is generally achieved by peer review (one team reviewing the work of another team and visa versa) or by a third-party audit team within the authority. Training on procedures and expectations of the authority is vital to achieving consistent quality of work among the staff.

When it becomes necessary to impose sanctions, they must be applied in an even-handed and consistent manner. This does not mean that every insurer receives the same sanction, but it does mean that the sanction imposed for one violation should be roughly as severe as the sanction imposed on another insurer for a violation of similar importance.

Insurers expect consistency of supervisory treatment within the financial sector generally, not simply between themselves and other insurers. This might be referred to as a “level playing field” for different types of institutions in the financial sector. With the growing prevalence of cross-selling of products and cross-ownership of institutions, it is increasingly necessary for financial sector supervisors to cooperate and coordinate their supervisory practices so that, as much as possible, they do not set rules or take enforcement actions that distort competition between market players.

A contributing aspect of achieving consistency is the knowledge that the insurers have about the supervisory methodology and the ways in which supervisory decisions are made. The more an insurer understands the methodology, the more likely it is to accept the need for remedial action. If an insurer feels it is being treated unfairly, it is more likely to object and take no action to remedy the deficiency.

Similarly, supervisory authorities must ensure that information released to the public is consistent and meaningful to the users of that information. This applies to all information released, whether by the supervisory authority, the industry as a whole (for example, a trade association), or individual companies. This goal can be achieved by consulting with the parties affected by the information that is released and discovering their needs and how they can be met reasonably. Often this consultation is done on an ongoing basis as comments and criticisms are filed with the supervisory authority. Action to strengthen the future release of information can then be planned.
H. Conclusion

The supervisory processes that are adopted and implemented in a jurisdiction should reflect the stage of development of the market and the requirements of the insurance core principles. Within these bounds, there is a great deal of choice. Designing the most appropriate processes for a jurisdiction involves judgment that balances the strengths and weakness of each option against the skills and resources available to the industry and the supervisory authority.

Accountability and transparency are important disciplines to demonstrate that supervisors carry out their duties in a timely manner and apply the processes and enforcement decisions even-handedly. Transparency also improves the level of understanding and acceptance by the general public and the regulated entities of the requirements and processes in place. This, in turn, increases the confidence that can be placed in the insurance sector as a whole.

While the supervisory processes are built on a foundation of information from the regulated insurers, the effectiveness of a supervisory authority is measured by what is done with this information. The processes for managing, interpreting, and transforming data into supervisory information, reaching supervisory conclusions, and taking timely and appropriate action are the topic of ICP 4 on supervisory process. These supervisory processes must be well defined and applied in a consistent and even-handed manner.

While appeals by insurers of the decisions made by the supervisory authority may not be enjoyable experiences, they should be an expected part of the supervisory process. A well-defined, well-communicated, and consistently applied supervisory process reduces the number of appeals. However, an appeals process should be established and communicated to the parties wanting to use that facility. Fairness and transparency in the appeals process can bolster the degree of confidence that market participants have in the supervisory process and the market in general.

Exercises

For each of the following questions, which responses are correct? Circle your choices. More than one may be valid.

24. Reliance on the work of others is an important supervisory tool because:
   a. It places responsibility for some of the supervisor’s work on others
   b. It increases efficiency by reducing overlapping duties
   c. It gets experts to do some of the work of supervision
   d. It reduces the supervisory authority’s legal liability
   e. It places the cost burden on the insurers.
25. The reliance assessment process is important because:
   a. It can improve efficiency of supervision
   b. It can determine whether the work performed is reliable
   c. It makes boards of directors understand what is expected of them
   d. It can lead to industry self-regulation
   e. It builds trust and mutual understanding.

26. Supervisors should be held accountable for their actions and decisions because:
   a. If they make a mistake they should answer for it
   b. With the power to remove the license of an insurer comes the responsibility to be fair and reasonable
   c. Supervisors need to report on how they used their power
   d. The legislative branch wants to know how effective the legislation is
   e. Supervisors have extraordinary powers to seek and receive any information they need to carry out their duties.

27. To whom are supervisors accountable?
   a. The legislative branch of government
   b. The public
   c. Policyholders
   d. Insurers
   e. The courts.

28. Transparency of supervisory processes means:
   a. Being open to new ideas
   b. Letting others know the processes used by the supervisory authority to do its job
   c. Continuous reporting on the work being performed
   d. Making available lots of written reports
   e. Describing clearly what one does, when, and how.

29. The annual report of a supervisory authority would usually include the following topics:
   a. Legislative authority
   b. Report on the state of the industry
   c. Statistical analysis of the industry compared to banking
   d. Staffing and cost of running the supervisory authority
   e. Report on whether the industry is getting stronger or weaker.
30. Why should a supervisory authority inform the public of its supervisory processes?

a. The supervisory authority works on their behalf  
b. Knowledge of what supervisors do contributes to public confidence  
c. Policyholders may want to contact the supervisory authority  
d. People want to know and have a right to know  
e. The insurers will not tell them, and somebody should.

31. Consistency in the way insurers are dealt with through the supervisory process is important because:

a. The same penalty should be applied whenever a violation occurs  
b. Comparing the financial strength of insurers can be done easily  
c. Insurers should be able to anticipate what will happen during the inspection process  
d. The onsite inspection staff are important to the success of the supervisory authority  
e. Supervisors should not abuse the power to remove a company’s license.

32. Consistency of supervisory decisionmaking can be achieved by:

a. Making sure that junior people do not make decisions  
b. Having written guidelines for the supervisory staff on when to apply what enforcement action  
c. Having clear decisionmaking authority assigned to each staff position  
d. Negotiating compliance actions with each insurer to be sure they accept the need to remedy their problem  
e. Publicizing a list of compliance actions that will be taken for which violations.

33. Delegation of decisionmaking authority within a supervisory authority can strengthen the effectiveness of supervision because:

a. Staff training programs that include sessions on decisionmaking can create a good group of people who could take management positions  
b. Including decisionmaking authorities in job descriptions makes the scope of decisionmaking authority clear  
c. Hiring competent staff strengthens the reputation of the supervisory authority  
d. Delegation distributes the decisionmaking process, and that enhances efficiency  
e. Delegation empowers the staff to take action when they see a violation.
For each of the situations described below, what would the practices in your supervisory authority be to deal with it? Can the procedures be strengthened and, if so, how?

34. An insurer is starting to sell motor vehicle insurance for heavy transport vehicles. Although the company’s experience in personal motor vehicle insurance has been quite good, heavy transport is a new risk area for the insurer, and its employees have not had much experience with heavy vehicles.

35. The board of directors of one of the major insurers has submitted a business plan that shows a planned 25 percent growth in sales in the upcoming year. They plan to achieve that by providing sales incentives for the agents and brokers while retaining the current product pricing strategy. The plan shows a decrease in capital over the year, but it would still be within the regulatory requirements.

36. You have just completed work on a troubled company that had to be put into liquidation. The legislative assembly has asked for a report on the way your supervisory authority handled the situation. They want to know why a failure was necessary.
I. References


Much information could be gained from reviewing information on the websites—and reading the annual reports—of other supervisory authorities, for example:

Appendix I. ICP 4: Supervisory Process

**ICP 4: Supervisory process**
The supervisory authority conducts its functions in a transparent and accountable manner.

**Explanatory notes**

4.1 The public's knowledge of and appropriate consultation on the supervisory process is important to the effectiveness and credibility of the supervisor. Accordingly, the supervisor should make available to the public written information about its organization and activities.

4.2 The supervisory authority should make available to the public the text of proposed and existing regulations. This would include not only substantive rules of general applicability but also policies and interpretations that are not confidential but that may affect a member of the public. The supervisory authority's public information should include information about how the public can interact with its officials. It would be appropriate also to describe the manner in which and on what timetable the supervisory authority intends to respond.

4.3 The supervisory authority must be accountable for actions it takes in fulfilling its mandate to those who delegated the responsibility—the government or legislature—as well as to those it supervises and the public at-large. It should provide the rationale for decisions taken.

4.4 In general, proper accountability requires a complex combination of approaches, such as legislative and executive oversight, strict procedural requirements, and disclosure. In addition, the supervisory authority establishes internal processes for ensuring it is meeting its objectives and complying with the legislation.

**Essential criteria**

a. The supervisory authority adopts clear, transparent, and consistent regulatory and supervisory processes. The rules and procedures of the supervisory authority are published and updated regularly.

b. The supervisory authority applies all regulations and administrative procedures consistently and equitably, taking into account the different risk profiles of insurers.
c. The administrative decisions of the supervisory authority can be subject to substantive judicial review. However, such action must not unduly impede the ability of the supervisory authority to make timely interventions in order to protect policyholders’ interests.

d. The supervisory authority makes information on its role publicly available.

e. The decisionmaking lines of the supervisory authority are so structured that action can be taken immediately in case of an emergency situation (refer to ICP 3, essential criterion n, and ICP 15).

f. The process to appeal supervisory decisions is specified and balanced to preserve supervisory independence and effectiveness.

g. The supervisory authority publishes a regular report—at least annually and in a timely manner—on the conduct of its policy, explaining its objectives and describing its performance in pursuing its objectives.

**Advanced criterion**

h. The supervisory authority provides and publishes information about the financial situation of the insurance industry and observations on major developments in the insurance or financial market.
Appendix II. Answer key

Pretest

1. b
2. c
3. c
4. b
5. a

Exercises

1. *ICP 4 requires each supervisor to adopt clear supervisory processes so that:*

   The staff of the supervisory authority understand their role, the insurers understand how the industry is supervised, and the general public can see how the work is done. Responses a, b, and c are valid.

2. *ICP 4 requires each supervisor to:*

   Be transparent in how it carries out its work, apply enforcement actions that reflect the risk profile of the insurer, and make decisions even though they may be appealed. Responses a, b, and e are valid.

3. *ICP 4 requires supervisory processes to be applied in a consistent manner. This means that:*

   Penalties of similar impact are applied for offences of similar importance. Response b is valid.

4. *ICP 4 requires that decisionmaking lines be structured because:*

   The staff need to understand the limit of their decisionmaking authority, doing so minimizes the potential for appeals to be successful, and the insurers need to understand how decisions are made and by whom. Responses a, b, and c are valid.

5. *The supervisory authority must be accountable for its actions because:*

   With power come responsibility and accountability, and it is in the best interest of the public to do so. Responses a and b are valid.
6. **ICP 4 requires that decisions made by the supervisor could be subjected to a judicial review:**

But the decision made by the supervisor should still be applied, and this should not impede the supervisor from making a timely intervention. Responses b and c are valid.

7. **Supervisors should have a mandate because:**

The supervisor can better understand the job, supervisory performance can be assessed against a preset goal, and it is clear what the legislative branch is expecting. Responses a, b, and c are valid.

8. **How a supervisory authority is organized is important because:**

The structure should be understood by the insurers and the public needs to understand how to deal with the supervisor. Responses c and d are valid.

9. **It is important for supervisors to make public the structure of the supervisory authority so that:**

The public can understand how to deal with the supervisory authority, the authority is not seen as secretive, and potential insurers know where to apply for a license. Responses a, b, and c are valid.

10. **The supervisory process can involve several approaches, including:**

Assuring that companies are in compliance with the law, focusing on critical risks in the industry, focusing inspection on the internal processes that companies use, and auditing the financial information for accuracy. Responses a, b, c, and d are valid.

11. **A supervisory process includes the following elements:**

Collecting information, analyzing information, filing information for later use, and talking to management in an insurer’s office about its business plan. Responses a, b, c, and d are valid.
12. It is important to match the stage of development of the insurance sector with the supervisory processes used because:

Using the staff effectively is important, the most advanced systems in the world require the most qualified people, to be effective supervisors must be realistic, and the industry has to be able to understand what is expected of them. Responses a, b, c, and d are valid.

13. Having adopted a supervisory process, the supervisory authority should:

Make its approach known to the public, be prepared to change it again, and encourage onsite inspectors to talk about it with the insurers. Responses a, b, and c are valid.

14. The compliance assessment approach has the following features:

It uses onsite inspection to look for violations of the law and regulations and is easy to understand, but can miss major risk exposures. Responses a, c, and d are valid.

15. The risk-focused approach has the following features:

Works well in a principles-based jurisdiction, can be simple or complex depending on how it is done, can miss a major issue of noncompliance in an insurer’s operation, and looks at how insurers should manage risk exposure. Responses b, c, d, and e are valid.

16. The process assessment approach has the following features:

Places reliance on the board of directors, places reliance on the insurer’s internal control procedures, and looks at risk in the same way that insurers should manage risk exposure. Responses a, b, and c are valid.

17. A cross-sector study is useful for the following reasons:

It identifies insurers that are better or worse than average, it provides information that may not be available using any other approach, it allows the supervisor to use industry practices as a supervisory tool, it can be as detailed as the issue justifies, and it can produce information that is helpful to insurers. All of the responses are valid.
18. Risk management includes the following features:

It identifies potential areas of risk within an insurer’s operation, measures risk, understands the risk and how it can be managed, and determines the materiality of the risk. Responses a, b, c, and e are valid.

19. Reviewing business plans during the analysis phase is useful because:

It can show whether the insurer is well managed, the plan shows the financial forecast for the insurer, it can show how good the insurer is at planning, it will show any new initiatives that the insurer has planned, and it could identify new risks and how the insurer will respond. All of the responses are valid.

20. It is important for supervisors to be prepared to handle crises because:

Crises can occur at any time, and readiness leads to prompt action when it is needed most. Responses a and c are valid.

21. One of the analysts in your office has come to you to seek advice on an insurer. The financial return that the insurer filed with your office shows a loss for the year in personal motor vehicle insurance and a claims ratio of 95 percent of premium income. Expenses account for 25 percent of premium on top of that. The analyst reports that premiums were set at the average of the rates charged by the insurer’s major competitors, and this produced a 10 percent increase in new policies over the prior year. He is developing the inspection plan. What would you suggest?

This line of business should be part of the inspection plan scheduled for detailed analysis. If the presumption is that the jurisdiction uses the compliance assessment approach, then looking for violations of the rules, including concentration limits, pricing strategies, capital plan, and provisioning should be a concern. If the jurisdiction uses a risk-focused approach, then a complete study of its risk measurement and risk management methodology would be useful. To understand what might be done in a more complete sense, talk to senior inspection staff at your supervisory authority about this situation and how they might handle it.
22. You are preparing an inspection plan for an insurer that has a local owner and a good capital position. You note, however, that the level of provision for claims incurred but not reported at the current year-end is below the provision held in the prior year, even though the volume of business has increased 15 percent. You have read a newspaper article indicating that the current owner is looking for someone to purchase the company. What would you suggest?

This situation should be reviewed in detail during the inspection. The focus could be on the adequacy of the provisions and the appropriateness of the values placed on the other assets and liabilities. Is the insurer being made to look stronger than it really is to attract a purchaser? The problem could be deeper than it appears on the surface. If you place reliance on the insurer’s accountant and actuary for these values, a review of their work and a discussion with them would be appropriate. Seek input from senior people in your supervisory authority for more suggestions.

23. You are preparing an inspection plan for an insurer that is an active investor in loans to medium-size businesses. The economy has deteriorated in the past year, and yet the value assigned to the loans has risen substantially. What would you suggest?

A review of the accounting policy for setting values for these assets is in order. If these loans are nonperforming (missed a few payments when due), how has this been treated? Does the insurer follow up when a payment is made and, if so, how and when? This situation could be acceptable, or it may be evidence of a deep financial problem. Only an onsite inspection can really tell.

24. Reliance on the work of others is an important supervisory tool because:

It places responsibility for some of the supervisor’s work on others, it increases efficiency by reducing overlapping duties, it gets experts to do some of the work of supervision, and, to a lesser extent, it places the cost burden on the insurers. Responses a, b, c, and, to a lesser extent, e are valid.

25. The reliance assessment process is important because:

It can determine whether the work performed is reliable, it makes boards of directors understand what is expected of them, and it builds trust and mutual understanding. Responses b, c, and e are valid.
26. Supervisors should be held accountable for their actions and decisions because:

With the power to remove the license of an insurer comes the responsibility to be fair and reasonable, supervisors need to report on how they used their power, and the legislative branch wants to know how effective the legislation is. Responses b, c, and d are valid.

27. To whom are supervisors accountable?

The legislative branch of government and the public. Responses a and b are valid.

28. Transparency of supervisory processes means:

Letting others know the processes used by the supervisory authority to do its job and describing clearly what one does, when, and how. Responses b and e are valid.

29. The annual report of a supervisory authority would usually include the following topics:

Legislative authority, report on the state of the industry, staffing and cost of running the supervisory authority, and report on whether the industry is getting stronger or weaker. Responses a, b, d, and e are valid.

30. Why should a supervisory authority inform the public of its supervisory processes?

The supervisory authority works on their behalf, knowledge of what supervisors do contributes to public confidence, and people want to know and have a right to know. Responses a, b, and d are valid.

31. Consistency in the way insurers are dealt with through the supervisory process is important because:

Insurers should be able to anticipate what will happen during the inspection process. Response c is valid.

32. Consistency of supervisory decisionmaking can be achieved by:

Having written guidelines for the supervisory staff on when to apply what enforcement action, having clear decisionmaking authority assigned to each staff
position, and publicizing a list of compliance actions that will be taken for which violations. Responses b, c, and e are valid.

33. **Delegation of decisionmaking authority within a supervisory authority can strengthen the effectiveness of supervision because:**

Delegation distributes the decisionmaking process, which enhances efficiency, and it empowers the staff to take action when they see a violation. Responses d and e are valid.

34. **An insurer is starting to sell motor vehicle insurance for heavy transport vehicles. Although the company's experience in personal motor vehicle insurance has been quite good, heavy transport is a new risk area for the insurer, and its employees have not had much experience with heavy vehicles. What would the practices in your supervisory authority be to deal with it? Can the procedures be strengthened and, if so, how?**

Talk to a senior person in your supervisory authority to see what the response might be. The insurer's ability to manage the risks arising from the new type of business might be assessed and, if significant concerns exist, supervisory actions might include requiring the insurer to put additional controls in place or putting restrictions on the insurer's license.

35. **The board of directors of one of the major insurers has submitted a business plan that shows a planned 25 percent growth in sales in the upcoming year. They plan to achieve that by providing sales incentives for the agents and brokers while retaining the current product pricing strategy. The plan shows a decrease in capital over the year, but it would still be within the regulatory requirements. What would the practices in your supervisory authority be to deal with it? Can the procedures be strengthened and if so, how?**

Talk to a senior person in your supervisory authority to see what the response might be. The supervisory response might include closely monitoring the level of sales and the persistency of the business or inspecting the processes used by the insurer to select and monitor the intermediaries with which it deals.
36. You have just completed work on a troubled company that had to be put into liquidation. The legislative assembly has asked for a report on the way your supervisory authority handled the situation. They want to know why a failure was necessary. What would the practices in your supervisory authority be to deal with it? Can the procedures be strengthened and if so, how?

Talk to a senior person in your supervisory authority to see what the response might be. Your response might include explaining the corrective actions that were taken by the supervisory authority and also explaining why it is impossible for a supervisory authority to prevent all failures.