ICP 1: Conditions for Effective Insurance Supervision

Basic-level Module
This module was prepared by Donald McIsaac. Mr. McIsaac joined the World Bank in 1993 as senior insurance specialist, working with client countries on reform of their social security systems, promotion of private pension and insurance sectors, and development of regulation and supervision. He has been involved in the Financial Sector Assessment Program, developing practices for assessments and conducting more than 20 assessments of the insurance and pension sectors. Prior to joining the World Bank, he served as director general in charge of supervision of life insurance companies in Canada for 15 years and, for part of that time, as acting deputy superintendent of financial institutions for Canada, with responsibility for supervising all types of private pension and insurance activities. His professional activities include extensive participation in the work of the Canadian Institute of Actuaries, including three years on the Executive Committee. He participated in international discussions organized by the Bank for International Settlements to review issues related to the supervision of financial conglomerates. His private sector experience as an actuary was with life insurance companies in Canada and the United States.

The module was reviewed by Udaibir S. Das and Monika Jurášová. Mr. Das, of India, has been extensively involved in developing the insurance aspects of the Financial Sector Assessment Program, the relationship between the International Monetary Fund and the International Association of Insurance Supervisors (IAIS), revisions to the insurance core principles, and the provision of technical assistance. He has written and published on aspects of financial regulation and its relevance to financial stability. Ms. Jurášová is currently working in the insurance sector. She spent 10 years with the Office of State Supervision of Insurance and Pension Funds in the Ministry of Finance of the Czech Republic, where she was a member of the Inspection Department, the International Department, and the Helsinki Protocol Working Group on Supervision of Insurance Groups. She held a short-term appointment with the European Bank for Reconstruction and Development in London in 2003.
Contents

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

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

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

B. Financial sector policy framework................................. 3

C. Financial stability......................................................... 8

D. Financial infrastructure conditions................................. 10

E. Financial market conditions........................................... 21

F. Building credibility....................................................... 24

G. Conclusion................................................................. 26

H. References................................................................. 27

Appendix I. ICP 1............................................................. 28

Appendix II. Answer key.................................................... 31
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
- 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 1: Conditions for effective insurance supervision module. This is a basic-level module on the conditions for effective insurance supervision that does not require specific prior knowledge of this topic. The module should be useful to either new insurance supervisors 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 a person will learn as a result of studying the module. 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 exercises are intended to provide a checkpoint from time to time so that you can absorb and understand the material more readily and can apply the material to your local circumstances. You are encouraged to complete each of these activities before proceeding with the next section of the module. If you are working with others on this module, develop the answers through discussion and cooperative work methods. An answer key in appendix II sets out some of the points that you might consider when tackling the exercises and 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. Explain why financial stability is essential to the functioning of the insurance sector
2. Explain how effective financial sector supervision contributes to the functioning of the insurance and other financial sectors.

3. Describe the essential elements of a well-functioning legal system and indicate why deficiencies would affect the operation of the insurance sector.

4. Explain the importance of accounting, actuarial, and auditing standards to insurance supervision.

5. Describe, in general terms, the essential criteria that such standards should meet.

6. Explain the roles of accounting, actuarial, and auditing professional bodies.

7. Briefly explain the steps a supervisory authority might take if faced with the following circumstances:

   a. Inadequate accounting, actuarial, or auditing standards
   b. Inadequate accounting, actuarial, or auditing resources within the jurisdiction
   c. The absence of professional bodies

8. Describe the types of economic, financial, and social statistics that should be available to the supervisory authority, the industry, and the public.

9. Explain the difficulties that can arise when such statistics are absent.

10. Describe the essential characteristics of well-functioning money and securities markets and explain their importance to the insurance sector.

11. Summarize the requirements of ICP 1.
ICP 1: Conditions for Effective Insurance Supervision

Basic-level Module

A. Introduction

Insurance markets, even in the most sophisticated economies, have developed and continue to evolve at a much faster pace than does the process of insurance supervision. However, the credibility of insurance markets, in the eyes of both domestic consumers of insurance services and international traders, is influenced to a great extent by the effectiveness of supervision. A trader planning to ship goods to another country and wishing to insure those goods against loss or damage will be very interested to know how dependable the insurance coverage in the receiving country might be. One of the first questions asked is whether the insurance business is being competently supervised. Likewise, domestic businesses may be obliged to seek insurance policies from insurance companies domiciled in other jurisdictions, perhaps for unusual or exceptionally large risks. These foreign insurers will be reluctant to offer such services in the absence of a properly functioning insurance supervisory system. The prospects for direct investment in the local insurance industry will also be diminished if foreign investors lack confidence in the supervisors.

Andrew Giffin, chairman of the International Insurance Foundation, writes:

Insurance is a part of, and dependent upon, a broader financial system. National, regional, and global markets need monetary units of exchange, payment systems, deposit systems, capital formation, investment media, credit systems, tax plans, and other fundamental financial system components. The development and stability of insurance markets depend on the development and stability of the whole financial system. Indeed, IAIS’s formation of the Core Principles was part of an
increased recognition that regulation of insurance is part of a broader regulatory scheme for financial services, which, in total, heavily influences financial stability in individual countries and globally.

The insurance supervisor is not in a position to control all the factors and influences that will bear upon the effective functioning, the competitiveness, and the integrity of the insurance markets in a country. Nevertheless, experience has shown that, by participating in activities such as regular consultation with professional organizations of actuaries and accountants, organizing and assisting with the training of insurance agents, brokers, and claims adjusters, building relationships with law enforcement authorities, and conducting workshops with judges and other public officials to help ensure that decisions and judgments in court cases are fair and equitable, supervisors can have considerable influence in certain areas that are not within their immediate sphere of responsibility. Of particular importance is the establishment of a means for regular consultation and dialogue with the central bank and with other financial sector regulators and supervisors on financial sector policy and market development issues.

This module seeks to identify those background or environmental conditions that have a critical impact on insurance supervision and that, in fact, influence the effectiveness of supervision of all parts of the financial sector. Where it is possible to do so, the module suggests steps that a supervisor can take to improve the existing conditions or at least to mitigate their impact on insurance supervision, if the prevailing conditions are less than optimal.

For the purposes of this module, the term “supervisory authority” is used to describe the office that is charged with responsibility for monitoring the condition of insurance companies, for enforcing regulatory requirements as specified in legislation, regulations, or guidelines, and for initiating the process of sanction or remedial action where this appears necessary. “Insurance supervisor” is the person holding that office. “Regulatory process” refers to the system by which laws, regulations, and guidelines are developed and formally adopted within a country.
B. Financial sector policy framework

The government and the central bank seek to ensure stable financial and macroeconomic conditions within the economy and to create conditions conducive to sound financial institutions that meet the needs of the public. The role of the financial sector in the overall economic and financial management thus becomes central in meeting the government’s stability and developmental objectives. A formal statement or a framework for the financial sector as a whole serves to clarify the roles and responsibilities of each sector and indicates the commitment on the part of the authorities to ensuring a well-functioning and financially sound financial system. Such a statement or framework could indicate the government’s intentions regarding the regulation and supervision of banking, for example, as well as regulation in areas such as insurance, securities markets, pensions, and other components of the financial system. The government’s objective for supervision thus is to ensure confidence in the institutions and in the system generally. The policy statement normally is issued before legislation is introduced to create the laws governing regulation and supervision.

Quoting from Mr. Giffin once again:

Regulation of business starts with the premise that it is necessary for the government, or government-sanctioned body, to regulate business activity to achieve desired public outcomes. Most businesses are subject to some basic legal protections such as property rights, enforcement of contracts, environmental protections, etc. Insurance is generally considered different from normal business in that it is essential for individual and societal protection and betterment. Objectives vary country to country, but they typically fall within a range of primary objectives. A major variation is the encouragement of development of a strong insurance industry where one has not yet developed. Many supervisory systems started with the objective of fostering the development of a strong, stable private or public/private insurance industry and later evolved to remove the development objective.

It is important to consider various points when drawing up a policy statement:

- **Privatization of state-owned entities.** An important consideration in such policy statements is the future of any financial institutions that are owned by the government. In some countries, the trend is to transfer these institutions to private ownership. In the field of insurance, state-owned institutions are sometimes the dominant players in the marketplace. If such an institution is to be transferred to private ownership, care must be taken to avoid the creation of a privately owned company that has a monopoly position in certain insurance products.
(see Vittas 1995). State-owned institutions should be subject to the same prudential requirements as all other financial institutions.¹

- **Development of a domestic insurance industry.** In most situations, the policy statement indicates the government's desire to promote development of a domestic insurance industry and identifies the benefits to be gained from deepening the local capital markets and increasing employment. In some cases, governments want to encourage the expansion of local companies into foreign markets to enhance the opportunities for growth and development. The government will seek to ensure that the only companies authorized to do business are those whose financial condition and market practices make it likely that they will be able to pay claims in a timely manner.

- **Deposit insurance.** In many countries, governments have adopted programs of deposit insurance to protect the savings that citizens have deposited with banks. Policy statements on the financial sector will usually reflect the government's intention to adopt such a program. It would also be useful to indicate what protections will be provided to savings that are entrusted to insurance companies.

- **Conglomerates.** The policy statement should indicate the government's intended policy regarding whether or not to separate the activities of banking institutions from those of non-banking institutions. Attention should be paid to the sale of insurance products by banks and the issue of deposit-type products by insurance companies. The statement should also indicate the government's intentions with respect to the formation of conglomerates, whether they are financial-only conglomerates or mixed conglomerates.

- **Rules governing related-party transactions.** A process is needed for identifying related-party transactions and for limiting their financial impact on the resources of a financial institution. Most countries either prohibit or severely limit any transactions between insurance companies and other persons or entities that have links to the owners or senior managers of the insurance companies. Even though it may be reasonable to suggest that such transactions will be done at market terms and prices, experience has shown that there is a great risk that the transactions will be entered into for reasons other than the best interests of the insurance company and its policyholders. For example, if the same person owns an insurance company and a corporation engaged in manufacturing, it is in the interests of the policyholders to ensure that the resources of the insurance company are not used to meet the financial requirements of the manufacturing corporation.

- **Ownership rules, including ownership by foreigners.** Some countries have judged it important to require that large institutions be widely held. In other words, no one entity may own more than a stated percentage of shares.

1. Applying different prudential requirements to state-owned companies than to all other companies places either customers or taxpayers (the owners) at greater risk of financial loss. It can also create competitive inequities, hindering the development of the privately owned insurance companies.
• Current account and capital account transactions. Any government restrictions on such transactions could affect the cross-border transfer of funds and investments and result in transfer risk as well (repatriation of dividends and profits, for example). This type of restriction could also have an impact on the availability and cost of reinsurance transactions with international companies.

The following areas of interest also should be included in the policy statement (see Skipper and Klein 1999; Achampong 1983):

• Admission of foreign companies into the marketplace
• Treatment of foreign direct investment in the financial sector
• Rules on competition and concentration of business
• Declaration of support for the campaign against money laundering and efforts to combat the financing of terrorism.

Establishment of a supervisory authority

In order to make the insurance sector function on a financially sound basis, the financial sector policy framework should support the establishment of a satisfactory regulatory and supervisory system. In this context, the responsibility for insurance supervision must be assigned to an agency or office with clearly defined mandate and powers. It is important to specify an appropriate venue for the supervisory authority. The policy statements should indicate whether the insurance supervisory authority is to be an independent office or whether it will form part of an integrated organization, such as the United Kingdom’s Financial Services Authority. The policy should specify the government ministry that will have responsibility for regulatory and supervisory issues in the insurance industry. In many cases, this will be the Ministry of Finance.

The policy should make it clear that the supervisory authority will operate independently of political influence and that measures will be put into place to ensure that it remains independent of the industry. Issues related to funding of the supervisory body are covered in ICP 3.

Legislation

Legislation provides the framework for supervision and defines the powers, roles, and responsibilities of the supervisor. At a minimum, the legislation should address the following:

---

2. In some jurisdictions, such as Australia, Canada, and the Netherlands, more than one supervisory authority may share the responsibility for insurance supervision. For example, one agency may conduct prudential supervision, while another supervises market conduct.
- Define the business of insurance
- Specify that no company or intermediary may solicit insurance in the country unless the supervisory body authorizes it to do so
- Provide the necessary powers for the supervisory authority to make rules and regulations as required to monitor the financial condition of authorized insurance companies, particularly with respect to the adequacy of the current resources of the company to meet any obligations arising under its policies.

It is important to ensure that the supervisory body is vested with all the authority necessary to apply a range of sanctions to those institutions and individuals that do not conform to regulatory requirements. In most countries, the principle of “natural justice” is applied, such that any company or individual that is to be subject to some form of sanction will have an opportunity to appeal the action to a court or other appropriate authority. However, the appeal must not block the initiative of the supervisory authority. In some unfortunate cases, appeals have had the effect of “staying” the application of sanctions, tying the hands of the authority, while allowing the problem or misbehavior to continue unchecked. This is clearly not a desirable situation. This can be avoided through careful wording of the provisions dealing with sanctions.

In some countries, self-regulatory organizations (SROs) assume part of the responsibility for supervising certain elements of the financial markets. In the field of insurance, such SROs are most commonly involved with the training and licensing of agents and brokers.

While most countries have established the broad framework for the system of regulation and supervision of insurance companies, various important features are commonly overlooked. In such cases, the supervisor can strengthen the system by recommending changes to the legislation and, where necessary, to the policy statements on the financial sector. For example, a supervisor might make recommendations on matters such as the following (see Savage 1998):

- Appointment of the supervisor for a fixed term with removal from office only for cause
- Authorization for collaboration and cooperation between supervisors of all segments of the financial sector (banks, securities dealers, insurance, and so forth). This is very important in light of the evolution of financial conglomerates
- Authorization for collaboration with counterpart supervisors in other countries. This is particularly important in dealing with insurance groups and supervising conglomerates (for example, early warning in a crisis situation within the group or conglomerate). It is also significant in the campaign against money laundering.

---

3. Insurers and intermediaries may also be permitted to carry on business on a services-only basis, through agreement with the jurisdictions in which they are domiciled and supervised. Such a system exists within the European Union.
- The treatment to be accorded to insurance company policyholders and claimants in the event of the liquidation or bankruptcy of an insurance company. Policyholders and claimants should be treated as a preferred class of creditor.

In general, the public policy statements for insurance will follow those established for the banks and other parts of the financial sector. This helps to ensure the smooth functioning of the system.

**Exercises**

1. Assume that you are the head of the insurance supervisory authority in your country. You have reported to the minister of finance that some insurance companies operating in the country are in poor financial condition. The minister is concerned that the failure of one or more of these companies could result in losses for policyholders when their legitimate claims are not paid in full and on time. The minister has asked whether it might be possible to design a program that would protect policyholders of insurance companies in the same way that deposit insurance protects the clients of banks. Using bullet points, identify the considerations that have to be covered in your reply to the minister’s inquiry.

2. Several of the major insurance companies that you supervise constitute important segments of the largest business conglomerates in your country. Using bullet points, identify the areas of concern that you would bring to the attention of the minister for inclusion in a policy statement addressing regulation of the financial sector activities of conglomerates.
C. Financial stability

An insurance contract is a promise to pay. A premium is collected today in exchange for a promise that a payment will be made at a future time. In many cases, the timing, the amount, and the likelihood of that future payment are unknown at the time the premium is paid. While there is much that is uncertain or contingent about the contract, it is clear that the contract is intended to run over a period of time. How can the parties to the contract be certain that the payments anticipated when the contract was made will still be adequate, relevant, and appropriate at the date of settlement? What issues must be considered?

Inflation

In one country that was suffering from rampant inflation, the issuers of automobile insurance policies encountered a serious problem. Some insurance policies included a promise to repair vehicles damaged as a result of covered accidents. However, inflation made it very difficult to set adequate and fair premiums, because six months after a group of policies was issued, the cost of replacement parts for damaged automobiles had risen to several times what it was when the policies were issued. The insurance companies faced bankruptcy or at least significant financial losses trying to honor the claims as they were presented.

Inflation also has disrupted financial planning in the field of long-term life insurance policies. In many situations, individuals paid premiums over an extended period of time for contracts in fixed amounts only to find that the benefits received at maturity had little or no buying power and thus did not provide the security originally intended.

Currency fluctuations

Macroeconomic stability involves other elements in addition to inflation. In some situations, fluctuations in currency exchange values can have an important influence, particularly in countries where it is common to issue contracts in different currencies. Movements in major currencies such as the euro and the U.S. dollar can have a serious impact on the financial stability of such markets.

Market volatility

Life insurance and pension contracts are often long term in nature. In the case of pensions, the arrangement can last as long as 60 years, if one considers the accumulation
phase and the payout phase together. In non-life (property and casualty) insurance, the coverage period of contracts is mainly of short duration, although some types of claims can take a long time to settle, so the average duration of claim provisions can be many years. This is particularly true of liability insurance contracts.

When contractual obligations are of such a long-term nature, insurance companies are obliged to plan their investment portfolios for the long term as well. With reasonable stability in the financial markets, this poses no problem. However, if the markets are more volatile, special measures must be adopted to absorb the shocks produced by the fluctuations. With this in mind, supervisory authorities in some countries set concrete rules and an approved structure of investments. Companies are obliged to adhere to the limits for items in the structure of the investments, which are stipulated by special regulation. This is the case, for example, for countries in the European Union or the European Economic Area. In the most mature markets, many derivative products are available that allow investment managers to hedge their risks and to alter the duration of an investment portfolio quickly and at reasonable cost. Such tools usually are not available in less mature markets. Since these markets are often volatile, investment managers and supervisors must be particularly vigilant.
**D. Financial infrastructure conditions**

Financial infrastructure covers the legal system, accounting and auditing standards, actuarial standards, professional organizations, and economic, financial, and social statistics.

**Legal system**

Insurance policies are contracts, usually of a voluntary nature, entered into by an insurance company and its policyholders. The legal system should protect both parties to the contract such that reasonable expectations arising from the contract will be met. There are several different legal systems in operation among the member countries of IAIS. The principal models that have been adopted are versions of either the British system of common law or the French (Napoleonic) code of laws. Regardless of the legal system in a particular country, the following common issues must be considered.

**Insurance legislation**

The government should pass legislation to establish a Law on Insurance. This law should give effect to the intentions outlined in the financial sector policy statements. It should describe the requirements and procedures for the admission and licensing of companies and provide the necessary authority for supervision. In most cases, the same law also deals with the plans for licensing agents, brokers, and claims adjusters. Under some legal systems, there must also be a Law on the Insurance Contract that provides the requirements for contract provisions and indicates the means of resolving disputes.

The Law on Insurance must provide a clear procedure for dealing with problem institutions. In addition to a range of possible sanctions, there must also be procedures for taking control of the business of the company in extreme situations and seeking remedies such as reinsurance in order to provide the greatest protection to the rights of the policyholders.

**Establishment of regulatory tools**

Experience has shown that the supervision of financial institutions proceeds most effectively if there are three levels of regulatory tools:

1. *Parliamentary legislation.* The highest level of regulatory tool is that of legislation adopted by parliament or the legislature. For practical reasons, legislation and amendments to legislation are sought less frequently than other regulatory
measures, owing to the difficulty of finding sufficient time for legislators to deal with insurance matters in the midst of the many other concerns that they face.

2. **Regulations issued by the minister.** The next level of regulatory tool is that of regulations issued by the minister responsible for insurance with the authority of the cabinet. The authority to make regulations in key areas should be given specifically to the minister through the basic legislation. An example would be the minister’s authority to make rules for risk-based capital. When the decision is made to adopt a risk-based capital system for the supervision of insurance companies, the system should be adopted through amendments to the insurance legislation. The legislation would identify the system in general terms and then delegate to the responsible minister the authority to prepare regulations containing the details for application of the rules.

3. **Guidelines issued by the supervisor.** The next level of regulatory tools consists of guidelines to be issued under the sole authority of the supervisor. Such guidelines are of general application to all companies, and compliance is expected. In practice, such guidelines usually should be issued by the supervisory authority after consultation with the industry. (Changes to legislation and the making of regulations should also be preceded by extensive consultation.) The supervisory authority would enforce the guidelines to the extent possible. If any company were found to be noncompliant with a guideline while all other companies were compliant, that company would become the target of close attention by the supervisory authority, using all the intervention powers available under the legislation and regulations.

**Issues of corporate governance**

Under any of the legal systems in use, there is usually a law regarding corporations (or “companies”) that defines the status of a corporation and identifies its rights and responsibilities. That body of law also provides some standards or requirements concerning corporate governance. In many situations, corporate governance rules are directed at protecting the interests of persons who invest in shares of a corporation. Policyholders clearly depend on the proper governance of the corporations from which they have purchased their policies to help ensure that policy obligations will be met. Insurance supervisors generally press for corporate governance rules that protect the interests of policyholders. Most jurisdictions have found it necessary to construct special corporate governance requirements that go beyond those specified for general-purpose corporations. Such provisions likely will have to be placed in the insurance legislation. An important example of this type of provision is that dealing with the role of the appointed

---

4. In some jurisdictions, at least part of the power to make regulations has been delegated to the supervisory authority. Although this delegation may facilitate the process of updating regulations, it is appropriate that such powers be subject to some constraints in order to avoid their abuse—for example, parliament may have the right to object to regulations within a specified period of time.
actuary. It would be helpful for the supervisory authority to ensure that the available laws also provide in some way for bankruptcy or liquidation. There must be adequate legal protection for the acquired rights of policyholders and claimants, should an insurance company go into bankruptcy. In many jurisdictions, legislation will also govern the making of contracts.

Contracts Law

The legal system should provide the means through which rights against collateral can be enforced. For example, if a lender has made a mortgage on the security of a parcel of real estate, the law must allow that lender to gain ownership of the real estate if the borrower fails to repay the loan. If this power does not exist, financial institutions will be discouraged from making loans on the security of property.

Settlement Mechanisms

Whatever the situation, it is important that there be some means whereby the parties to an insurance contract can settle disputes in a reasonable period of time. If a dispute can only be settled through a court action, and it takes years to bring a case before the court, there is a risk that one or the other of the parties to the contract will be treated unfairly. In some countries, alternate dispute resolution systems permit a tribunal or ombudsman to resolve a dispute, thus sparing the expense and most of the time involved in a court action.

It may not be desirable to make dispute resolution the responsibility of the supervisory authority. The duties involved could interfere with the ability of the authority to perform the other important functions of the position and might create a “conflict of interests” situation with respect to the supervised companies.

Court System

The legal system also encompasses the court system in a country. There need to be courts that are competent to hear cases arising from business transactions. Even with the best alternate dispute resolution system, some disputes, because of their size and nature, must proceed to a court for final resolution. The courts should deliver, and be perceived to deliver, fair and reasonable judgments. Resources, in terms of court times and competent judges, must be sufficient to permit decisions within a reasonable period of time.
LAW ENFORCEMENT

Consideration of the legal system must also take into account the system of law enforcement. Police officers are very helpful as impartial witnesses in disputes involving drivers of automobiles, for example. In some countries, insurance supervisors have found it helpful to conduct training sessions for judges and police officers in order to alert them to the issues arising from insurance contracts and the type of disputes they produce. In some circumstances, insurance supervisors will also need to work with law enforcement authorities, such as the police or the public prosecutor, to accomplish supervisory objectives. For example, the sanctions for some offences include imprisonment, and a search warrant may be needed to obtain documents from the home of a senior executive suspected of fraud.

Exercise

3. You are responsible for the supervision of insurance in your country. You have received a number of complaints from companies providing automobile insurance to the effect that the companies are becoming reluctant to carry on business any longer. They explain that whenever there is a dispute over a claim, the courts appear to side with the consumer against the insurance company, no matter what evidence is presented in court. How would you propose to deal with this situation?
Accounting and auditing standards

Crucial elements in the supervision of financial institutions include assessing the financial condition of the supervised institutions and monitoring the profitability of their operations. This information is obtained in the first instance from the financial statements that supervised institutions present to the authority. The extent to which the supervisor can rely on published financial statements depends on the quality of the accounting and auditing standards in use in the country and on how effectively such standards are applied.

Financial reporting standards prescribed for all types of corporations, including insurance companies, should emphasize the importance of timely and accurate disclosure of all relevant items in the accounts of a company. Standards should deal with the following:

- The form of presentation of results
- Valuation of individual asset and liability items
- Reporting of income and expenditure to prevent undue deferment of losses and premature recognition of gains
- Methods for accrual of items of income and expenditure and for amortization of changes in asset values
- Reliance on the work of other professionals. (For insurance companies, in particular, this relates to the extent to which the auditor relies on the work of the actuary, in case the actuary has prepared estimates for some liability items such as the technical provisions. It also includes the extent to which the actuary relies on the work of the auditor in verifying the detailed information on policies in force that is contained in the records of the company.)

The disclosure requirements for supervisory purposes and for proper disclosure to policyholders are more comprehensive than those designed for estimating taxes payable.

The International Accounting Standards Board has taken steps that will lead to the adoption, in many parts of the world, of International Financial Reporting Standards. As more countries adopt these standards, reporting will become more uniform and more consistent. At present, these standards are not uniformly applied, and there has been some delay in producing specific rules to cover insurance contracts. In the absence of a complete set of international accounting standards, some countries do not have a uniform standard of financial reporting for insurance companies, and different companies use different accounting practices to prepare the reports filed with the supervisory authority. This makes it difficult to compare the results of the different companies and can produce misleading results.

In order to avoid this situation, supervisors can adopt a number of measures. In countries where the responsible professional body has not prescribed uniform, con-
sistent accounting standards for insurance companies, the supervisory authority itself could prescribe such standards. For example, this could be done by designing forms that all insurance companies must use when reporting to the supervisory authority. Thus the instructions for completing the form would constitute uniform accounting standards. In this way, the supervisor would collect results submitted in a consistent manner by all companies. The supervisory authority could also insist that the results appearing in the prescribed form be verified by the company auditors.

Legislation would be required in order to ensure that the supervisory authority has the power to issue instructions regarding the presentation of accounts and to take the necessary action if the results indicate financial problems.

This draconian approach is not the most desirable. In the ideal situation, the supervisory authority will specify that all companies must present their financial statements in accordance with accepted accounting principles as they are defined by the local professional body or other standard setter. As a caveat, the supervisory authority may reserve the right to override any specific provision that is perceived to have the effect of disguising the true financial position of the company.

It may happen that a given company is doing business in countries where national or international standards apply, while operating in a market in which the regulatory body has prescribed its own standards. In such cases, the company will be obliged to conform to the requirements of all of the various jurisdictions in which it operates and may be obliged to present its results in several formats.

In addition, there are other issues to consider:

- **The setting up of provisions.** In general, accounting rules for insurance companies should prescribe that a portion of all premiums received be set aside, as a liability, until the period or risk for which the premium has been paid has expired. In many cases, this involves establishing an “unearned premium” provision that represents the proportion of the initial period of coverage that has not expired on the date that the financial statement is prepared. In other cases, particularly those involving long-term or life insurance policies, the provision is developed using actuarial techniques. In either case, it is important that the premiums received do not flow immediately to the “bottom line.” Another fundamental consideration is the setting aside of reasonable provisions for claims that are in the course of settlement or adjudication and where final payments to claimants remain to be made.

- **Investments in subsidiaries.** Accounting rules for financial institutions should also prescribe what treatment is to be accorded to investments that companies have made in subsidiary corporations. Either a deduction of capital or a consolidation approach must be taken in order to avoid the risk of “double-gearing” of capital. In the European Economic Area, for example, there are specific
accounting rules for reporting within an insurance group, and these rules are designed to avoid the risk of double-gearing.

- Loans in default. When loans made by financial institutions encounter a default on payment of principal or interest, it is important that the institution discontinue the practice of accruing outstanding interest on the loan once it is determined that repayment is unlikely.

Similar to the situation with respect to accounting, the International Auditing and Assurance Standards Board has developed international standards on auditing and is encouraging their adoption worldwide. Auditing standards adopted by the local standard-setting or professional body should include sampling techniques and the preparation of prescribed working papers in the course of the audit. The responsibilities of the auditor are in some respects similar to those of the supervisory authority’s inspectors, and efforts should be made to promote collaboration between them, thus avoiding duplication of effort. However, insurance supervisors are interested in issues, such as technical provisions, assessment of risk, and quality of the investment portfolio, that are not necessarily covered by an external audit.

Exercise

4. You are responsible for the supervision of insurance in your country. You have become concerned that the accounting practices of insurance companies operating in the country are not providing you with all the information you need in order to assess the business and financial condition of the companies. Let us suppose that no uniform method exists for reporting the financial results of insurance organizations and that companies follow a variety of accounting rules. (In some countries, the only accounting rules in use were designed by government taxation authorities in order to identify income received by corporations and thus ensure that all taxes are paid.)

a. To prepare yourself to deal with this problem, identify the types of information that you would hope to obtain from the financial reports submitted by insurance companies. For this part of the exercise, think of the optimal package of financial information.

b. What practical steps will you take in order to ensure that, within a short period of time—perhaps a few years—companies are providing their financial information in a uniform manner, including the desirable level of detailed information that an insurance supervisor requires?
Actuarial standards

The financial statements of insurance companies are influenced to a major extent by the estimates of its liabilities under insurance contracts, often prepared for the company by an actuary. In many situations, especially in life insurance (long-term insurance), the liabilities estimated by the actuary may be the largest item on the balance sheet. In addition, the prices that companies charge for their insurance policies are usually developed using actuarial techniques and assumptions. For this reason, appropriate actuarial standards should be adopted and applied consistently.

In reporting the operating results for a business year, the increase in the liabilities is applied as an item of expenditure. Thus, if the actuarial estimates of the liabilities are set at a high or conservative level, the operating gain will usually be smaller (or the loss will be greater, if the overall results are reported to be in a loss position). Likewise, if the actuarial estimates are set using more liberal assumptions and methods, the gain on operations will usually be greater (or the loss will be smaller, if the overall results are reported to be in a loss position).  

Unfortunately, acceptable standards that give adequate coverage to the many techniques and assumptions that may be selected by the actuary have been promulgated in relatively few countries. As a consequence, for the majority of countries, the actuarial profession has not provided complete guidance to its members on the preparation of their estimates and the reporting of results. In some countries, actuaries follow a variety of approaches, even to the selection of different methods for valuing policies (British, Canadian, and American). In all such circumstances, the lack of consistency in the results presented by the companies renders comparisons between companies less meaningful and supervision more challenging.

In order to respond to this situation, supervisors have in some cases prescribed a specific set of rules to be followed. In this approach, the standards prescribed are essentially copied from those of other countries where the profession has set more complete standards.

Owing to the importance of actuarial estimates, supervisory authorities have adopted a variety of measures in an attempt to verify the results reported by the actuary. One scenario involves the retention of a consulting actuary to review all of the returns filed. Thus, regardless of the reporting or valuation standards employed by the company actuary, the consulting actuary could provide an opinion on their acceptability and on the accuracy of the results. This procedure is costly for the supervisory authority unless the fees of the consultant can be charged to the companies.

In certain countries, the actuarial profession is well established, in terms of both the numbers of practitioners and the thoroughness of standard-setting performed by the professional organization. In some such cases, governments have prescribed that each insurance company must name an “appointed actuary” (see IAIS 2003). This person is

6. The effect on the operating result, when considered over time, will be more neutral, as any margin for conservatism will reduce the result when it is established but will be released back as an increased result when it is no longer needed—that is, when the policy has expired and claims are paid out.
given special responsibilities, is subject to provisions designed to support professional objectivity and limit conflicts of interest, and reports directly to the board of directors of the insurance company on the affairs and prospects of the company. In addition to commenting on the adequacy of the current resources of the company to meet any obligations arising under its policies, the appointed actuary may also be required to prepare a forecast of the capacity of the company’s resources to absorb certain future shocks that might affect the business of the company and its investments. The actuarial profession would be expected to provide guidance to practicing actuaries in the preparation of these special “financial condition” reports.

The development of actuarial standards has proceeded much further in the field of life insurance than in non-life insurance. Numerous “standard” mortality tables are available, and basic valuation techniques are often incorporated in software packages that can be purchased in the public domain. However, with the increased complexity of modern insurance products and with the difficulty of forecasting longevity under annuity products, it is not obvious that acceptable estimates can always be produced using purchased software.

For non-life insurance, the development of actuarial standards is not so far advanced. However, many jurisdictions have found it necessary to call on the company actuary to confirm the adequacy of the claim provisions and to submit a report in support of the findings. In other jurisdictions, the auditor is asked to provide an opinion confirming the adequacy of the provision for outstanding claims.

Professional organizations

The work of supervision is greatly aided by the existence of effective and vigorously functioning professional organizations. Such organizations have established standards for training, experience, and ethical behavior that qualify candidates for membership. In the ideal situation, they have continuing education requirements to ensure that their members remain up-to-date with the latest developments. The supervisory authority is expected to collaborate with the associations and to consult with them on new policy initiatives, to encourage the strengthening of the associations and contribute to their work on development of standards, and to promote the training of new members of the professions.

In the case of insurance, the key supporting organizations are associations of actuaries and of auditors. Effective functioning of the insurance markets is possible only when there is a sufficient supply of these professionals in the marketplace. The supervisory authority itself will likely be obliged to obtain the services of such qualified professionals, either as staff members or as independent consultants retained from time to time, as needs dictate.

The professional associations establish standards to govern the work of their members. The standard-setting is a continuous activity as circumstances change. For ex-
ample, various national accounting bodies are involved in extensive work in order to ensure that their standards remain consistent with the new international standards being prescribed by the International Accounting Standards Board. A disciplinary process should be in place to deal with cases where members of the associations fail to conform to the expectations of the standards.

**Economic, financial, and social statistics**

The work of insurance supervision must include the monitoring of developments in the larger economy if it is to be effective, with particular emphasis on emerging developments that can cause financial problems for insurance companies and possible losses for policyholders.

The supervisory authority and others need to have speedy access to the following basic indicators:

- Rate of growth in the economy (GDP)
- Rate of inflation and rate of increase in average wages
- Rates of investment return
- Movements in currency exchange rates
- Movements in market prices of traded securities, particularly shares of corporations
- Movements in real estate values
- Trends in population mortality, demographic composition of the population, and forecasts for the future
- Rates of unemployment.

In many countries, managers of financial institutions and the people responsible for supervising them are developing tools and techniques for stress testing. This process involves creating models for the portfolio of business and the assets owned by an institution and then subjecting the assumptions used in those models to certain stresses in order to assess the capacity of the resources of the institution to respond to changing circumstances without risk of loss to their depositors and policyholders. The stress test scenarios are usually developed from the list of factors given above.

Growth in the economy, usually measured by the growth in GDP, is of interest to insurance managers and supervisors since it is an indicator of likely future growth in business. Also, any slowdown in economic activity could indicate a reduction in insurance sales coupled with a risk of loss in the value of certain assets.

If we consider rates of investment return, investment managers and the supervisory authority will find it necessary to construct “ladders” of yield rates by length of time to maturity. If this type of ladder can be constructed for, say, government-issued securities, then a grid can be developed that will enable them to develop a fair or market
value for securities issued by corporations. Such information is also essential in arriving at appropriate assumptions for the discount rates required to calculate insurance liabilities, particularly those under long-term life insurance and annuity policies.

Population mortality is of interest to persons involved in the design of annuity products. If the demographic trend is to greater longevity, then insurance company actuaries, and the supervisory authority, will want to ensure that the improving life expectancy is taken into account when establishing prices and technical provisions for annuity policies.

The non-life insurance industry will wish to collect industry-wide data on claims experience. Smaller companies are unable to collect sufficient data to provide rates of claim that are “credible” in a statistical sense. If industry-wide data can be assembled, companies and the supervisory authority can develop appropriate assumptions regarding the expected rate of claims.

Exercise

5. You are the insurance supervisor in your country. Identify the types of macroeconomic and demographic data that you would need for your ongoing supervisory work. In the event there are critical gaps in information, suggest ways to overcome those limitations.
E. Financial market conditions

This section covers the importance of financial markets to insurers and some factors that affect the functioning of the financial markets.

**Importance of financial markets to insurers**

Insurance companies act as financial intermediaries, and they are important players in the financial markets of a country. In most situations, they are among the major institutional investors (along with pension funds), and their highly liquid operations create a great demand for securities of all types. In some countries, investment operations of insurance companies and pension funds represent the greatest share of turnover on the stock exchange.

The long-term nature of many of their investment activities, particularly those of life insurers, and the promises they make under the policies they offer in the marketplace prompt insurance company investment managers to pursue investment opportunities very aggressively with an eye to both term and yield. However, in order to be prepared to meet the demands arising from unexpected claims, they must remain in a position to liquidate asset positions promptly and without great cost.

These demands prompt insurance company investment managers to develop highly diversified portfolios and to practice aggressive asset liability management (ALM) policies in order to maximize returns without sacrificing the security they have promised to their clients. An important part of a sophisticated ALM strategy is the use of derivative products, including hedging. Such products enable companies to match their obligations with investments of appropriate yield and term, while retaining access to the liquidity they require.

In order to achieve this type of investment program, financial markets in a country must be highly developed with a good number of securities that trade in considerable volumes on a daily basis. In countries where trading is more restricted, insurance companies must adopt more conservative investment practices with a resultant reduction in the promises they can make to their policyholders. In all countries of the European Economic Area, for example, regulations specify the maximum level of the technical interest rate for calculating the majority of long-term insurance products, dependent on the current level of development in the financial markets.

In the absence of active trading, institutional investors often adopt a “buy and hold” strategy. If the majority of the securities available in a marketplace are absorbed and retained by a few institutional investors, it will be difficult to ascertain a fair market value for those securities at a given point in time, and the results of an attempt by any one player to liquidate a position will be difficult to forecast.

Insurance companies sometimes participate in the money, bond, and equity markets as issuers and intermediaries. As issuers, insurers need to raise long-term capital or
secure other financing, while keeping financing costs and balance sheet risks low. But if markets are either shallow or inefficient, they may constrain the portfolio choices for the insurers. Deep and efficient markets are therefore essential.

**Factors influencing the functioning of financial markets**

Market depth and efficiency depend on several factors, including macroeconomic stability, a diverse investor base, a sound regulatory framework, robust payment and settlement systems, an appropriate legal framework, and a supportive tax regime. Some other conditions that could affect the functioning of markets include high and volatile inflation, unsustainable debt levels, balance-of-payments vulnerability, and an overvalued exchange rate. As a consequence, the market may exhibit high risk premiums or a low investor appetite.

From the point of view of issuers and investors, weakness or shallowness of markets could affect the desired balance sheet structure or lead to execution risk. Mark-to-market and disclosure requirements will also have a bearing. The extent to which foreign investors are permitted access to domestic securities markets also affects the functioning of the financial markets. Regional market arrangements can contribute to market depth.

Financial market infrastructure and the regulatory regime governing the markets are also important. Necessary conditions for well-functioning financial markets include adequate and readily enforceable contracts, insolvency procedures, and governance structures. These conditions build confidence in the integrity of the market and support price transparency and provisions designed to counter market abuses.

The tax framework could also affect insurers’ market options. For example, all types of income from all types of investments and savings should be treated fairly. Transactions made should reflect views on the value of the underlying instrument rather than tax incentives. The system should also help to enhance price efficiency and reduce the operational costs associated with collecting tax.

Efficient money markets are a key requirement for liquid capital markets. They provide financial intermediaries with a mechanism for funding positions and support active risk management by market participants. The conditions of the money market could be affected by the policies and operations of the central bank and the overall monetary policy framework.
Exercise

6. You are the insurance supervisor in a country where the money, bond, and capital markets are at a very early stage of development. In reality, the only investment opportunities available to contractual savings institutions such as insurance companies are (a) securities issued by the local government and (b) bank deposits. Clearly, this situation is not optimal and constrains the ability of the insurance companies to manage their balance sheet risks. What practical steps can you take to overcome the market weakness? What proposals can you make, and to whom, in order to foster a deeper and well-functioning securities market in your country that will be beneficial for the insurance industry?
F. Building credibility

In order for the insurance supervisory authority to discharge its functions effectively, the supervisor must have credibility within the financial markets. The government takes the first step toward establishing this credibility when it issues its policy statement confirming the establishment of a supervisory authority for insurance companies and indicating its intention to regulate and supervise the business of insurance in order to protect consumers.

Legislation and the government should then empower the supervisory authority to take an active role in the development of laws, regulations, and guidelines to implement the plans for supervising the insurance business. It is important for these regulatory instruments to be relevant and effective in producing a safe and sound insurance market. As part of this process, it is important for the supervisor to develop a culture of consultation with industry representatives as well as to collaborate with other relevant public authorities.

The supervisor should collaborate with and enter into information-sharing agreements with counterparts in other domestic regulatory agencies and also with insurance supervisors in other countries whose insurance markets are pertinent (for example, the activities of insurance groups and conglomerates, offshore business, reinsurance activities).

Credibility is enhanced through regular communication with the supervised companies. Regular inspections are an important test to convince company officials that rules will continue to be applied uniformly to all players in the local market. Consistent interpretation is important, including ensuring that the treatment of insurance companies is consistent with that afforded to other types of institutions for similar products. The marketplace will expect the supervisor to enforce integrity in the reporting of financial results by all players and must be able to assume that the supervisor will take the steps necessary to eliminate from the marketplace any companies that do not conform to the requirements. The regulatory system should provide the power to do so and treat all regulated entities equally (see OSFI 1999).

The supervisor should take an active interest in the training and licensing of the agents, brokers, and claims adjusters who deal directly with the insuring public. While these responsibilities can sometimes be delegated to trade associations, the supervisory authority must retain responsibility for ensuring that opportunities for abuse of the public are minimized. As noted in the subsection on settlement mechanisms, it may be unwise to position any dispute resolution mechanism in the office of the supervisor. Nevertheless, the supervisory authority should communicate with the tribunal, ombudsman, or other officials in order to monitor the level of complaints related to insurance companies’ dealings with the public. A significant volume of complaints against a particular institution should be regarded as an important “early-warning” signal.
Further material regarding conditions to enhance the credibility of insurance sector supervisors may be found in the supporting documents for the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* (see IMF 1999).
G. Conclusion

The work of supervision in any country will have to be carried out within the realities of the environment that exists in that country. The government can aid in the development of an effective supervisory regime by establishing clear and comprehensive policies for the financial sector and for the regulation and supervision of financial institutions. To the extent that these policy statements are not complete, the supervisor can work with officials in the appropriate ministry to update the policy statements. Most countries find it appropriate to review the situation from time to time. In Canada, the government is committed by legislation to a five-year review of the financial service legislation.

One of the key tools for the insurance supervisor is the insurance legislation, taken together with any the regulations promulgated under that law. While the making of legislation is the responsibility of the government and the power to make regulations may lie with the competent minister rather than the supervisory authority, the supervisor is the recognized expert in the field. As a consequence, the supervisory authority is in an excellent position to formulate recommendations on a regular basis that will lead to improvements in the regulatory framework, in line with emerging international best practices.

Other factors influencing the insurance markets, such as macroeconomic conditions and the depth of the capital markets, are outside the direct influence of the insurance supervisor. However, the supervisory authority should develop tools for the constant monitoring of these conditions and can use its authority to insist that companies develop asset liability management and other contingency plans such that they should be able to cope with whatever conditions emerge without compromising their ability to meet the expectations of their policyholders.
H. References


Appendix I. ICP 1

ICP 1: Conditions for effective insurance supervision

Insurance supervision relies upon

- A policy, institutional, and legal framework for financial sector supervision
- A well-developed and effective financial market infrastructure
- Efficient financial markets.

Explanatory notes

1.1 Implementation of the principle depends on the existence of a sound financial policy and institutional environment as well as a properly functioning financial sector and legal infrastructure.

1.2 This is essential for the supervisory authority to perform its functions and meet its supervisory objectives effectively. The lack of any, or a combination of, essential conditions could affect the quality and efficacy of insurance supervision.

1.3 This principle identifies elements of the economic, legal, and financial sector environment and the supporting market infrastructure that need to be present. In most jurisdictions, these elements are not defined or controlled by the supervisory authority and are also required for the effective functioning of other sectors as well.

1.4 The existence of an effective financial sector policy and an appropriate institutional and legal framework is necessary to ensure the stable and efficient operation of the financial system. It also facilitates formal and closer coordination among the relevant supervisory authorities and with the government and enhances stakeholders’ confidence in the supervisory regime. Good laws alone are not enough. The legal system must provide support in honoring and enforcing insurance contracts.

1.5 Another essential condition for effective supervision is for the supervisor to establish credibility and respect in the market vis-à-vis stakeholders, especially insurers and intermediaries. Credibility and respect are a function of many factors, including relevant laws and rules, consultation with the industry, and the quality of supervision and supervisory staff.

1.6 Similarly, insurance supervision can be severely constrained by inadequacies in the financial sector infrastructure, such as weaknesses in the national accounting standards or the lack of actuarial skills and insurance expertise. Accurate financial data require qualified experts including accountants, auditors, and financial analysts and ac-
cess to reliable and comparable economic and social statistics for the proper evaluation of risks. In order to conduct asset liability management, broad-based, liquid, and well-functioning money and securities markets are also essential.

1.7 Where the conditions for effective insurance supervision are not yet sufficient, the insurance supervisor could have additional powers to put in place rules and procedures and prudential rules to address the weaknesses.

**Essential criteria**

**Financial sector policy framework**

a. The government establishes and publicly discloses a policy statement aimed at ensuring financial stability, including the provision of effective financial sector supervision covering the insurance and other financial sectors.
b. An institutional and legal framework, comprising public institutions, laws, and regulations, exists for financial sector issues, including those pertaining to insurance, to address system-wide issues. This framework is well defined and publicly disclosed.

**Financial market infrastructure**

c. There is a reliable, effective, efficient, and fair legal and court system (a body of ethical, professional, and trained lawyers and judges) whose decisions are enforceable. Alternative dispute mechanisms operate within an appropriate legal framework.
d. Accounting, actuarial, and auditing standards are comprehensive, documented, transparent, and consistent with international standards. Accounting and actuarial standards are applied and disclosed in a manner that allows current and prospective policyholders, investors, intermediaries, creditors, and supervisors to properly evaluate the financial condition of insurers.
e. Accountants, actuaries, and auditors are competent and experienced and comply with technical and ethical standards to ensure the accuracy and reliability of financial data and its interpretation. Auditors are independent from the insurer.
f. Professional bodies set and enforce technical and ethical standards. These standards are accessible to the public.
g. Basic economic, financial, and social statistics are available to the supervisory authority, the industry, and the public.
EFFICIENT FINANCIAL MARKETS

h. Well-functioning money and securities markets exist to support the availability of both long-term and short-term investment opportunities.

Advanced criteria

i. Laws and regulations are updated, as necessary, to reflect current best practices and industry conditions.
Appendix II. Answer key

1. Assume that you are the head of the insurance supervisory authority in your country. You have reported to the minister of finance that some insurance companies operating in the country are in poor financial condition. The minister is concerned that the failure of one or more of these companies could result in losses for policyholders when their legitimate claims are not paid in full and on time. The minister has asked whether it might be possible to design a program that would protect policyholders of insurance companies in the same way that deposit insurance protects the clients of banks. Using bullet points, identify the considerations that have to be covered in your reply to the minister's inquiry.

- The first line of defense is a sound, effective system of supervision. Recommend a risk-focused approach with an adequate system of early-warning indicators. No compensation program should be considered until the risk of failure has been reduced to an acceptably low level.
- Consider a program of compensation for policyholders who suffer losses when an insurance company fails.
- Losses can be compensated using an assessment of other, healthy, companies operating in the industry, but subject to some kind of limits, such that failure of one company will not produce a domino effect in the industry.
- Compensation should be limited in amount such that protection is applied mainly to the less sophisticated clients with smaller amounts at risk.
- Government may wish to provide a backstop or guarantee of borrowing rights for the compensation program.
- All companies must participate in the program, and any assessment must be a legal obligation for any company operating in the market.

2. Several of the major insurance companies that you supervise constitute important segments of the largest business conglomerates in your country. Using bullet points, identify the areas of concern that you would bring to the attention of the minister for inclusion in a policy statement addressing regulation of the financial sector activities of conglomerates.

- Supervision can be applied most effectively when financial activities are kept separate from nonfinancial activities within a conglomerate. In other words, the financial organizations within a conglomerate should carry on only financial activities and should be regulated in the same manner as any other like institution.
- There should be careful controls and limits on any transactions between the financial institutions and other corporations related to them through the conglomerate.
• Supervisors should have access to all the necessary information relating to the supervised institution, including information that must be obtained from the parent institution or other sister corporations within the conglomerate. Supervisors must be particularly attentive to financial transactions between the supervised institution and the parent.
• Supervisors should have unimpeded access to financial information regarding any downstream subsidiaries of the supervised financial institution.
• Legislation should prescribe limits for portfolio investments by insurance companies and should specify the types of corporations that may be approved as downstream subsidiaries for insurance companies.
• Legislation should define the types of activities that can be conducted by an insurance company and by any of its approved downstream subsidiaries.

3. You are responsible for the supervision of insurance in your country. You have received a number of complaints from companies providing automobile insurance to the effect that the companies are becoming reluctant to carry on business any longer. They explain that whenever there is a dispute over a claim, the courts appear to side with the consumer against the insurance company, no matter what evidence is presented in court. How would you propose to deal with this situation?

In the first instance, it would be important to collect statistics regarding the number of claims that have been reported and their resolution, along with information on the processes that companies use to settle their claims. Then it would be helpful to examine the circumstances of the cases that have been presented to the courts for adjudication.

You could also establish an ombudsman service and invite policyholders to contact the ombudsman to seek a mediated solution to a disputed claim rather than to seek resolution through the courts.

If it turned out that, in fact, the majority of judgments are in favor of the claimant and against the insurance companies, then it will likely be necessary to launch an information campaign. You could seek to make judges and other key players in the legal process more familiar with the nature of insurance products and with the rights and responsibilities of participants in the insurance contract. In such a contract, the rights of both the person insured and of the insurance company must be respected.

In some countries, supervisors have found it effective to conduct seminars in order to help judges to understand the role that insurance seeks to play in an economy.

In most countries, operators of motor vehicles are required to maintain third-party liability insurance coverage on their vehicles. However, it is difficult to enforce this requirement without the cooperation of the public (operators of
motor vehicles) and the police force. Members of the police force are in the best position to monitor compliance of motorists with the insurance requirement. The supervisor could organize meetings with police authorities to reinforce the fact that the requirement exists in order to protect persons who suffer loss at the hands of an uninsured motorist. It might be possible to create some incentives and some simple tools that will help with the task of enforcing the insurance requirement.

4. You are responsible for the supervision of insurance in your country. You have become concerned that the accounting practices of insurance companies operating in the country are not providing you with all the information that you need in order to assess their business and financial condition. Let us suppose that no uniform method for reporting financial results of insurance organizations exists and that companies follow a variety of accounting rules. (In some countries, the only accounting rules in use were designed by government taxation authorities, in order to identify income received by corporations and thus ensure that all taxes are paid.)

a. To prepare yourself to deal with this problem, identify the types of information that you would hope to obtain from the financial reports submitted by insurance companies.

For this part of the exercise, think of the optimal package of financial information.

- Balance sheet, showing both book and market values of assets
- Statement of income and expenditure
- Statement of changes in the value of the company’s equity (capital and surplus)
- Statistics on premium income, summarized by type of business and distinguishing new business from renewal business
- Data on claims incurred, claims paid, claims in dispute, and a runoff indicating the rate at which outstanding claims are being settled
- Information on the rate of termination of policies
- Details on provisions (reserves) set aside for unpaid claims, including unreported claims
- Information supporting any provisions made for unexpired risks

b. What practical steps will you take in order to ensure that, within a short period of time—perhaps a few years—companies are providing their financial information in a uniform manner, including the desirable level of detailed information that an insurance supervisor requires?
• Contact local accounting professionals. In the ideal case, there will be an association of accountants. Also, in most situations, there will be representatives of the major international accounting firms operating in the country. Their support should be solicited.
• Contact the local insurance industry trade association and point out the shortcomings with the local system of financial reporting. Enlist the support of key insurance industry specialists to work on this problem.
• The supervisory authority should be conversant with emerging best practices as they are being developed by the IAIS and by the International Accounting Standards Board and other organizations. For example, the European Union has developed a comprehensive set of financial reporting requirements for insurance companies.
• The supervisory authority would draw these developments to the attention of the industry and the accounting profession and establish a dialogue that should lead to the elaboration of an acceptable set of accounting standards to be employed by insurance companies in the country.

5. You are the insurance supervisor in your country. Identify the types of macroeconomic and demographic data that you would need for your ongoing supervisory work. In the event there are critical informational gaps, suggest ways to overcome those limitations.

Macroeconomic data are available from many sources—both public and private. In well-established and open economies, this information is readily available. In less developed economies, the sources of reliable data may be limited. The supervisory authority could take practical steps such as the following:

• Designate a member of the staff of the supervisory office to be responsible for assembling and analyzing economic information. The analysis should include an assessment of the likely impact of economic developments on the profitability and financial well-being of the insurance companies.
• Promote the development of effective sources of macroeconomic information. In many cases, this can be accomplished through local universities. Material gleaned from the types of reports routinely available in the developed economies can form a foundation for the type of data collection that an emerging market economy would seek.
• Maintain a continual dialogue with the insurance companies operating in the country in order to determine whether the companies share the same assessment of developing situations. These discussions would also lead to the development of action plans for confronting the economic and marketplace scenarios that are identified.
• Cooperate with the country’s banking and securities supervisors in the development and analysis of data on the financial sector.

6. You are the insurance supervisor in a country where the money, bond, and capital markets are at a very early stage of development. In reality, the only investment opportunities available to contractual savings institutions such as insurance companies are (a) securities issued by the local government and (b) bank deposits. Clearly this situation is not optimal and constrains the ability of the insurance companies to manage their balance sheet risks. What practical steps can you take to overcome the market weakness? What proposals can you make, and to whom, in order to foster a deeper and well-functioning securities market in your country that will be beneficial for the insurance industry?

Consider the possibility of permitting each insurance company to invest a portion of its assets in securities issued by foreign governments or corporations based in other countries. For the initial stages, this might include only those securities issued by a restricted group of countries known to be better established in securities trading. It is important to set the limits on such investments with a close eye on the risks from foreign exchange. Carefully monitor the experience of companies that do invest a portion of their assets outside the country. If this has been favorable, gradually increase the proportion of assets supporting local liabilities that can be invested outside the country.

The insurance supervisor can play a leadership role in guiding the development of a system of securities trading in the country. You will need to develop rules for the safe custody of assets. If possible, steps could include establishing a centralized securities depository with electronic trading of assets and promoting a securities commission that will supervise the trading of securities.

The supervisory authority also can draft regulations governing the investments of local insurance companies. These should contain both qualitative and quantitative measures. In the absence of a local securities-rating service, the qualitative limits should include rules that depend on the credit history and earnings record of the issuer. The supervisory authority should also take steps to promote the development of a competent local securities ratings service.

Quantitative investment limits should be established to minimize the risk of undue concentration of investments in securities of a given type or a given issuer. Rules should also be prepared to strictly limit any non-arm’s-length transactions.