ICP 13: Onsite Inspection

Basic-level Module
This module was prepared by Michael Hafeman, an actuary and independent consultant on financial sector supervision and related issues. He has held senior positions in both private and public sector organizations in the financial services industry in Canada and the United States. Most recently, he was assistant superintendent of the Specialist Support Sector at Canada’s Office of the Superintendent of Financial Institutions (OSFI), and he served as a member of the Executive Committee and the Technical Committee of the International Association of Insurance Supervisors (IAIS) and as chair of its Solvency Subcommittee. He is a member of the Public Interest Oversight Board, charged with overseeing the auditing and assurance, ethics, and education standard-setting activities, and the Member Body Compliance Program of the International Federation of Accountants. He serves on the Insurance Program Advisory Committee of the Toronto International Leadership Centre for Financial Sector Supervision.

The module was reviewed by Ana María Aznar, Benoit Courmont, and Judith Roberge. Ana María Aznar is a lawyer and insurance supervisor (inspectora de seguros del estado) with the General Directorate of Insurance and Pension Funds of Spain. She has worked in various departments and, for many years, has been involved in the international aspects of the work of the authority, participating directly in the work of international organizations on the subjects of insurance and pension funds. Benoit Courmont is an insurance supervisor with the French insurance supervisory authority. Judith Roberge is a senior analyst in the Capital, Accounting, and Research Division of Canada’s Office of the Superintendent of Financial Institutions (OSFI). In her 17 years with OSFI, she has had held positions as supervisor of non-life insurers and pension plans and as senior international liaison officer. She has represented OSFI on the IAIS Task Force on the Revision of the ICPs and serves as a member of the Groupe des Superviseurs Bancaires Francophones. She has an MBA from Les Hautes Études Commerciales, Montreal.
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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 13: Onsite inspection module. This is a basic-level module on on-site inspection that does not require specific prior knowledge of this topic. The module should be useful to either a new insurance supervisor or an experienced supervisor who has not dealt extensively with the topic or is simply seeking to refresh and update 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, and answer the questions in the pretest to help gauge 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 parts 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. You are encouraged to complete each of these activities before proceeding with the next section of the module. You will also find questions dealing with the local situation and related to practices in your jurisdiction. These are intended to help you apply the material in this module to your local circumstances. 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 in appendix II 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 the relationship of onsite inspection to overall supervision
2. Show how materiality and risk influence the design and conduct of an efficient onsite inspection
3. Contrast the roles of onsite inspectors and external auditors, illustrating the ways in which an onsite inspection (a) might rely on the work of external auditors and (b) should not rely on the work of external auditors
4. Explain the use of analytical review procedures in planning an inspection
5. Distinguish testing of controls and substantive testing and explain how effective use of the former reduces the need for the latter
6. Design an inspection of a particular insurer’s internal control structure
7. Prioritize inspection activities according to the related risks
8. Plan and schedule a full-scale onsite inspection efficiently
9. Describe appropriate uses of focused (limited-scope) inspections
10. Illustrate the objectives and practicalities of onsite inspections of intermediaries
11. Discuss the powers necessary to obtain information as part of an onsite inspection
12. Illustrate situations where a supervisor might need to extend an onsite inspection beyond the insurer to obtain information
13. Communicate with company management concerning the purpose, scheduling, conduct, and results of an onsite inspection
14. Develop a follow-up process to ensure that a particular insurer’s plans to take corrective action in response to the findings of an inspection are implemented effectively
15. Summarize the requirements of ICP 13.
Pretest

Before studying this module on onsite inspection, answer the following 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 or most relevant.

1. The fundamental reason for conducting onsite inspections of insurers is to:
   a. Verify compliance with the insurance laws and regulations
   b. Help assess current and prospective solvency
   c. Confirm the accuracy of financial statements
   d. Detect instances of fraud
   e. Limit the need for costly offsite analysis.

2. Onsite inspections should be conducted:
   a. Annually, of the entire business of each insurer operating within the jurisdiction
   b. Only with respect to the parts of an insurer’s operations that have not been reviewed by the internal or external auditors
   c. Only of insurers that are experiencing solvency difficulties
   d. Periodically, with the scope and frequency of the inspections taking into account the risk profile and financial position of the insurer.
3. **Substantive testing may include:**
   a. Discussing the work of the audit committee with its chair
   b. Observing the work being performed by the insurer’s staff
   c. Reconciling a material amount shown in the financial statements to the underlying accounting records
   d. Reviewing reports prepared by the insurer’s internal auditors.

4. **An effective program of onsite inspections may best be planned:**
   a. In detail before beginning inspection activities for the year, with the plan followed precisely, in order to enable supervisory staff and the insurers to plan their work effectively
   b. In broad terms before beginning inspection activities for the year, with specific inspections decided no more than one month in advance, in order to avoid “window-dressing” by the insurers
   c. In detail before beginning inspection activities for the year, with the plan reviewed each quarter and modified as necessary, in order to accommodate requests for deferral from insurers that are busy dealing with operational problems
   d. In broad terms before beginning inspection activities for the year, but with detailed plans established each quarter, in order to deal with new priorities that might arise during the year.

5. **Which of the following activities may not be necessary as part of a full-scale onsite inspection?**
   a. Evaluation of the insurer’s management and internal control system
   b. Analysis of the insurer’s relationships with external entities
   c. Assessment of the insurer’s financial strength
   d. Detailed recalculation of all of the insurer’s technical provisions.

6. **Focused inspections should only be used when the resources of the supervisory authority are insufficient to allow annual full-scale inspections of all insurers.**
   a. True
   b. False.

7. **It is essential that all onsite inspection activities be performed only by staff of the supervisory authority.**
   a. True
   b. False.
8. **An onsite inspection may need to extend beyond an insurer to obtain information if the insurer:**
   
   a. Has outsourced some of its processing to another company  
   b. Refuses to provide information that has been requested  
   c. Operates branches in foreign jurisdictions  
   d. Has provided insurance to government agencies.

9. **The results of an onsite inspection generally should be communicated to the insurer:**
   
   a. On a preliminary basis during or at the end of the inspection, followed by a written report once findings have been analyzed more carefully  
   b. Only through a written report that has been approved by the head of the supervisory authority  
   c. Only if serious problems are discovered  
   d. Through a detailed report to its board of directors.

10. **The supervisory authority’s follow-up with an insurer to ensure that corrective actions planned in response to the findings of an onsite inspection are being effectively implemented should involve:**
    
    a. Weekly onsite visits, so that implementation cannot fall significantly behind schedule  
    b. Monthly telephone calls, so that the insurer can focus its efforts on implementation, rather than spending a lot of time dealing with the supervisory authority  
    c. More frequent and formal financial reporting by the insurer  
    d. A note attached to the file to ensure that the implementation is reviewed during the next onsite inspection  
    e. One or more of the above, depending on the nature of the findings.
ICP 13: Onsite Inspection

Basic-level Module

A. Introduction

Onsite inspection is considered by most supervisors to be an important part of the supervisory process. The Insurance Core Principles (ICPs; see IAIS 2003c) of the International Association of Insurance Supervisors (IAIS) has a principle on onsite inspection, ICP 13, which states:

The supervisory authority carries out onsite inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

The ICPs and the Supervisory Standard on Onsite Inspections (IAIS 1998) have much to say about different types of onsite inspections and how they can be useful. However, neither these documents nor the IAIS glossary (IAIS 2006) actually define what is meant by “onsite inspection.” Perhaps the absence of a definition is because the meaning of the term is readily evident. After all, a dictionary may tell you that an inspection is an official examination or review, while “onsite” indicates that the inspection takes place wherever the subject of the inspection happens to be located.

An alternative explanation is that the wide variety of purposes for onsite inspections and practices followed in performing them, along with philosophical differences regarding their role in the supervisory process, make it difficult to take the definition any further than the one implied above. However, this situation hints at the power and
flexibility of onsite inspections as a tool that can help a supervisory authority to achieve its objectives.

The balance of this section includes a brief discussion of the objectives and processes of supervision, the roles that onsite inspection can play within this broader context, and some significant aspects of onsite inspection that are highlighted by ICP 13. Section B deals with the onsite inspection program as a whole, describing the different types of inspections and discussing how they might be incorporated in the work plans of the supervisory authority. It also considers the extent to which a supervisory authority might rely on the work of others in achieving an effective and efficient onsite inspection program. Section C discusses the various steps involved in carrying out an onsite inspection, including planning and preparation, fieldwork and its documentation, assessment and reporting of findings, and post-inspection follow-up.

**Supervisory objectives and processes**

ICP 2 requires that the principal objectives of supervision be defined clearly and goes on to state, in essential criterion b, that they should “promote the maintenance of efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders.” Supervision should help to protect consumers from the risk that insurers will be unable to meet their obligations. Supervisory activity directed at achieving this objective is known as prudential supervision. Consumers may also suffer loss if insurers and intermediaries do not deal with them fairly. Supervisory activity directed at ensuring fair treatment of consumers is known as market conduct supervision. In some jurisdictions, prudential and market conduct supervision is performed by different supervisory authorities.

How can the objectives of supervision, whether prudential or market conduct in nature, be achieved? Although the insurance market can be very complex and supervising it is not a simple task, it may be useful to draw a parallel to a common activity: a sporting event. If the insurance market is like the game, then the insurers and intermediaries are the main participants, and the supervisory authority is the referee. (Unlike a sporting event, however, the insurance consumers are not simply spectators but actually participate in the game! The referee must therefore take special care to protect them.) In order for the game to run smoothly and fairly, the rules of the game must be clear and understood by the participants. The referee must keep a close eye on the game to see whether the participants are playing by the rules. Finally, if things are not going as they should, the referee must have the power to take action and use this power to get the game back on track.

In the context of insurance supervision, the rules of the game can be many and complex. They include general and insurance laws, regulations, guidelines, solvency requirements, and accounting, actuarial, and auditing standards. The practices commonly expected of market participants, even if not explicitly written down, can be considered
unwritten rules of the game. The ICPs deal extensively with these rules, particularly in the sections on conditions for effective supervision (ICP 1), the supervised entity (ICPs 6–10), prudential requirements (ICPs 18–23), and markets and consumers (ICPs 24–28).

Like a referee, the supervisory authority must have a clear view of the game. It needs to understand the business activities and financial situations of the various market participants. Also, in order to achieve the objectives of market efficiency and stability, a supervisory authority must have a comprehensive understanding of what is going on in the insurance market as a whole. The ICPs indicate that a supervisory authority should have processes for accomplishing its monitoring (ICP 4), including cooperating with other authorities (ICP 5). The need for an overview of the market is highlighted by ICP 11, while ICPs 12 and 13 deal with the monitoring of specific market participants. ICP 17 addresses the need to keep an eye on the activities of a group of which an insurer is a member.

The need for a supervisory authority to take action to keep the “insurance game” running smoothly and the nature of the actions it might take are dealt with by some of the ICPs on ongoing supervision (ICPs 14–16). The need for processes that will support fair and timely action by the supervisory authority is highlighted by ICP 4.

The IAIS has outlined a new framework for insurance supervision (see IAIS 2005), represented graphically in figure 1. In the context of the sporting analogy, the rules of the game are contained within levels 1 and 2, while the work of the supervisory authority as referee is represented by level 3.

Regulatory requirements, if properly formulated, should support the prudent operation of insurers and the successful functioning of the insurance market, thereby protecting consumers. Supervisory authorities have traditionally focused largely on assessing whether insurers and intermediaries are complying with regulatory requirements. A supervisory authority would, for example, verify that an insurer is following corporate governance rules, investing assets within regulatory limits, valuing liabilities

![Figure 1. Outline of the framework for insurance supervision](image-url)
adequately, and meeting solvency margin requirements. The rationale for this focus, known as the compliance assessment approach to supervision, is that if the rules are formulated properly and followed strictly, the result will be satisfactory.

Increasingly, supervisory authorities have come to realize that, although complying with regulatory requirements is necessary, compliance alone may not be sufficient to produce a satisfactory outcome. The complexities of the insurance business and commercial realities make it impossible to design regulatory requirements that will, even if followed, ensure the achievement of supervisory objectives. Many circumstances can cause an insurer to fail, and not all of these are easily dealt with through specific regulatory requirements. This point is reinforced in a comprehensive study by the Committee of the Conference of Insurance Supervisory Services of the Member States of the European Union (2002), which shows that the most obvious causes of solvency problems were “the inappropriate risk decision, the external ‘trigger event,’ or the resulting adverse financial outcomes. However, further analysis showed that these causal chains began in each case with underlying internal causes, being problems with management or shareholders or other external controllers.”

In response to this realization, many supervisory authorities have begun to adopt supervisory approaches that explicitly consider how insurers manage their business. For example, the process assessment approach focuses on the internal control procedures established by insurers. This approach is built on the premise that insurers should have robust internal control procedures in order to know what is happening and be confident that the work is being done to the standards set by management and the board.

Another approach, known as risk-focused supervision, explicitly considers the various risks that are faced by an insurer or intermediary and how well these risks are being managed (for example, see FSA 2003; OSFI 1999). Supervisory analysis of risks may focus on the various significant activities of an insurer, which could, for example, be a line of business, a geographic area of operation, or a department within the company. Taken together with an analysis of an insurer’s current and prospective financial situation, the supervisory authority can develop an overall assessment of the risk that the insurer will be unable to meet its obligations to policyholders.

The module on ICP 4 on the supervisory process provides information about these supervisory approaches and the advantages and disadvantages of each. As it also points out, supervisory authorities often incorporate aspects of each approach in their work. The relative emphasis placed on each may vary to reflect differences in factors such as supervisory philosophy, the stage of development of the market, the extent to which the supervisory authority can rely on the work of others, and the capabilities of supervisory staff.
Roles of onsite inspection

So what roles can onsite inspections play in the supervisory process? The most obvious answer is that an onsite inspection can give the supervisory authority a first-hand look at what is going on, as part of the supervisory assessment called for by level 3 of the framework. Such first-hand contact can contribute greatly to the effectiveness of the supervisory authority, whether it is taking a compliance assessment approach, a process assessment approach, or a risk-focused approach to supervision. Likewise, it is relevant to the assessment of financial, governance, and market conduct matters. A few examples are provided below.

The assessment of an insurer's compliance with financial requirements generally begins with the offsite analysis of financial statements and financial regulatory returns that are submitted to the supervisory authority. Some supervisory authorities extensively analyze such information. Their confidence in the reliability of this information may be bolstered by the knowledge that robust accounting, actuarial, and auditing standards exist and the expectation that they are being applied by competent professionals. Even in such cases, there is often room for the exercise of judgment in the application of standards, and an important element of an insurer's balance sheet—its liabilities—is only an estimate of the ultimate obligations of the insurer. An onsite inspection can provide the opportunity to check the reliability of the data underlying the financial statements and review and discuss the assumptions, methods, and systems used by the insurer to calculate the various elements of the financial statements. The calculations can be checked, and the processes employed by the insurer to test the adequacy of technical provisions can be reviewed. If the financial reporting standards are weak or the supervisory authority lacks confidence in their application, extensive onsite work may be required in this area.

Although certain characteristics of governance can be assessed through offsite analysis, it is impossible to assess fully the quality of governance without an onsite inspection. For example, in an offsite analysis, the composition of the board and its committees can be compared with legal requirements, the minutes of board meetings can be reviewed to determine whether the meetings were held as required, and internal audit plans and reports can be analyzed. However, an onsite inspection enables the supervisor to assess the effectiveness of the insurer's decisionmaking processes, the capabilities of its management and staff, and the manner in which its internal controls are being applied. In general, it can provide the supervisor with a sense of how well run an insurer is.

The first-hand contact with the operations of an insurer and the ability to build personal relationships with members of its staff can help a supervisor to identify problems at an early stage. Sometimes, a supervisor will identify significant issues that had escaped the attention of management or that management had identified but chosen to ignore or to hide. Once they know and have confidence in the supervisor, staff of an insurer may well bring such issues to the supervisor's attention.
Onsite inspections can also play a role in the intervention activities of a supervisory authority. An onsite inspection provides the supervisor with the ability to raise issues of concern with management on an informal basis, perhaps before they develop into major problems. It also enables the supervisory authority to better assess the situation of the insurer and reach supervisory conclusions. More formally, the documentation of concerns arising from an onsite inspection provides the basis for further corrective measures, enforcement actions, and sanctions that may be necessary if the concerns are not resolved satisfactorily. In some jurisdictions, this latter role is recognized in the legislation, which explicitly requires that an onsite inspection be performed before certain supervisory actions may be taken.

The benefits of an onsite inspection can extend well beyond the period in which the supervisors are on site. The understanding of an insurer's operations, the relationships with members of its board, management, and staff, and the first-hand knowledge of the challenges faced by insurers and intermediaries in complying with regulations can be valuable to a supervisor. They can help the supervisory authority to identify significant issues more readily during its offsite analysis, to obtain relevant information more quickly, to understand the operations and risks faced by the industry more thoroughly, and to formulate more appropriate policies.

In summary, supervisors have much to gain by venturing out of their offices and conducting onsite inspections. Onsite inspections are an essential supervisory tool in their own right and can contribute to the effectiveness of other supervisory activities.

**Overview of ICP 13**

As mentioned, ICP 13 requires the supervisory authority to carry out “onsite inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.” In interpreting this short statement of principle, two things are particularly notable. The first is that onsite inspections should not be considered an optional part of the activity of a supervisory authority. The second is that onsite inspections should be used to examine both the business of an insurer and its compliance with legislation and supervisory requirements. While it does not require that both aspects be covered as a part of every inspection, it does mean that one aspect should not be used to the exclusion of the other.

ICP 13 is accompanied by various explanatory notes that help to put it in context, along with six essential criteria that should be met in order for an onsite inspection program to be effective. The full text of ICP 13, the explanatory notes, and the essential criteria are included as appendix I. The criteria are discussed briefly in this section, and the issues they raise are discussed at greater length in sections B and C.
Essential criterion a highlights the need for a supervisory authority to have the legal power to conduct onsite inspections. It is impossible to have an effective inspection program if the supervisory authority needs the permission of the party it wishes to inspect before going on site. In such a situation, those in greatest need of an inspection are the least likely to grant permission.

The reference to wide-ranging powers means that the supervisory authority should have the flexibility to adjust the nature, scope, timing, and frequency of onsite inspections to different situations and supervisory needs. A law that would permit an onsite inspection only if the supervisory authority has reason to believe that an insurer is in breach of solvency requirements does not provide such flexibility.

As mentioned, information gathering is an important role of onsite inspections. If the supervisory authority does not have sufficient powers to obtain the information that it needs while on site, it will not be able to investigate the areas of concern fully.

Essential criterion b requires that the information in regulatory returns be verified periodically through onsite inspections. Supervisors are not to take such information as accurate simply because the party submitting the returns says it is, nor should they rely entirely on offsite analysis to identify problems with this information. However, it does not require that every item of information on every regulatory return be verified every time a return is submitted. In other words, a sampling process may be employed.

It also indicates that the supervisory authority may entrust external auditors or other suitably qualified parties with the task of onsite verification, as an alternative or supplement to doing the work itself. In such cases, the need for communication between the supervisory authority and the party that performed the review is essential. It would be appropriate for such communication to be open and substantive, to facilitate the discussion and resolution of concerns arising from the review.
Essential criterion c elaborates on one of the aspects of flexibility mentioned in the discussion of essential criterion a: the ability of the supervisory authority to establish the scope of an inspection. The differences between full-scale and focused inspections, and the situations in which each might be used, are discussed in section B of the module.

d. The supervisory authority promptly discusses findings and any need for corrective action with the insurer and obtains appropriate feedback from the insurer.

Essential criterion d calls on the supervisory authority to discuss its findings and any need for corrective action promptly with the insurer. Such communication is in the best interests of the supervisory authority, the insurer, and consumers. If problems exist, the sooner the insurer discovers them, the sooner they can be corrected and the risks to consumers reduced. If the supervisor has no concerns, it is also appropriate that the insurer receive this feedback promptly, so that it (and the supervisory authority) can get on with other things. Although it may take some time to consider the findings of an inspection and determine the necessary corrective actions, the supervisory authority should not delay the process unduly.

This criterion also requires that a discussion take place and that the supervisory authority obtain appropriate feedback from the insurer. Although an onsite inspection generally will result in a formal, written communication of the most significant findings and required actions from the supervisory authority to the insurer, this should not be the only communication. The insurer should have the opportunity to correct any factual errors in the findings and, in most cases, discuss the importance of the findings and alternative approaches to dealing with any supervisory concerns.

e. The supervisory authority follows up with the insurer to ensure that any required action has been taken.

Essential criterion e highlights the importance of following up to ensure that an insurer has taken any required action. There is little point in raising an issue with an insurer and securing the insurer's agreement that it will deal with the concern, only to find during the next inspection that nothing was done. Even worse, the problem may be so serious that the insurer's inaction caused it to become insolvent before the next inspection! ICP 14 on preventive and corrective measures and ICP 15 on enforcement or sanctions expand on the tools that a supervisory authority might use in connection with its follow-up activities.
Essential criterion f recognizes that intermediaries and companies to which an insurer has outsourced functions can play significant roles in the operation of an insurer. The supervisory authority should have the power to extend its onsite inspections beyond the confines of the insurer itself, in order to obtain information from such parties. Without such information, it may be impossible for the supervisory authority to form a complete picture of the risks to which an insurer is subject and the adequacy of the controls that should be in place to deal with these risks.

**Commonly used terms**

Before delving further into the topic of onsite inspection, it is important to define some commonly used terms. Many of the definitions are taken from the IAIS glossary (see IAIS 2006), although some clarifications and additions have been made. Some definitions have been taken from the glossary found in the *Handbook of International Auditing, Assurance, and Ethics Pronouncements* (see IFAC 2006); they are identified as IFAC.

**Available solvency**: Surplus of assets over liabilities. The first sense of the term is the surplus evaluated in accordance with domestic regulation—either rules of public accounting or special supervisory rules. The second sense is the surplus taking into account domestic requirements as regards eligible capital elements. In other words, the second sense is surplus as the amount of capital available to cover the required solvency margin in accordance with domestic law or supervisory regulations. (See IAIS 2006 for a mathematical formula for calculating available solvency.)

**Control activities**: Those policies and procedures that help to ensure that management directives are carried out. Control activities are a component of internal control (IFAC).

**Control environment**: Includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity’s internal control and its importance in the entity. The control environment is a component of internal control (IFAC).

**Corporate governance**: See governance.
**Cross-border provision of services:** Provision of insurance on a services basis (without local establishment) in a jurisdiction other than the company’s home jurisdiction.

**Domestic/foreign:** Inside/outside the jurisdiction. In connection with an insurer, domestic or foreign refers to the place where the company concerned is incorporated, irrespective of the place of incorporation of its parent company.

**Financial conglomerate:** Any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (for example, banking, securities, insurance).

**Financial regulatory returns:** Financial statements and reports prepared for a supervisory authority in accordance with a financial reporting framework and format that are designed to meet the needs of the supervisory authority for information on an entity’s financial situation.

**Financial statements:** A structured representation of the financial information, which ordinarily includes accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term can refer to a complete set of financial statements, but it can also refer to a single financial statement—for example, a balance sheet or a statement of revenues and expenses—and related explanatory notes (IFAC).

**Governance:** The role of persons entrusted with the supervision, control, and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions (IFAC).

**Home jurisdiction:** Jurisdiction in which an insurer has its head office or, in the context of a group, in which an insurer’s parent is incorporated. Due to the hierarchical corporate structures of many groups, both immediate and higher-level home jurisdictions may exist.

**Host jurisdiction:** Jurisdiction in which a foreign insurer operates by way of a local branch; in the case of the cross-border provision of services, the jurisdiction in which the service is provided or, in the context of a group, in which an insurer that is a subsidiary or joint venture of a foreign parent is incorporated.

**Home/host supervisor:** Supervisor of the home/host jurisdiction.
**Insurance group:** A group structure that contains two or more insurers. The structure of international insurance groups may derive from an ultimate holding company that is not an insurer. Such a holding company can be an industrial or commercial company, another financial institution (for example, a bank), or a company the majority of whose assets consist of shares in insurance companies (and/or other regulated financial institutions).

**Insurer/insurance company:** A legal entity that underwrites insurance.

**Internal auditing:** An appraisal activity established within an entity as a service to the entity. Its functions include, among other things, examining, evaluating, and monitoring the adequacy and effectiveness of internal control (IFAC). A related, but slightly broader, definition developed by the Institute of Internal Auditors is that an internal audit activity is a department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

**Internal control:** The process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control consists of the following components: (a) the control environment, (b) the entity's risk assessment process, (c) the information system, including related business processes, relevant to financial reporting and communication, (d) control activities, and (e) monitoring of controls (IFAC).

**Jurisdiction:** A territory with local insurance laws that relate to the incorporation or operation of insurance companies. This territory, as a rule, is the national territory and, at the same time, the territory of the insurance supervisor’s competence. In certain cases, this may be the territory inside a nation with a federal structure—for example, the states making up the United States.

**Monitoring of controls:** A process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions. Moreover, monitoring of controls is a component of internal control (IFAC).

**Nonfinancial regulatory returns:** Reports, other than financial regulatory returns, prepared for a supervisory authority in accordance with a specified reporting format.
that are designed to meet the needs of the supervisory authority for information on an entity’s situation.

**Solvency:** Ability of an insurer to meet its obligations (liabilities) under all contracts at any time. Due to the very nature of insurance business, it is impossible to guarantee solvency with certainty. To come to a practicable definition, it is necessary to clarify the circumstances under which the appropriateness of the assets to cover claims will be considered. For example, will only written business (run-off basis, break-up basis) be considered, or will future new business (going-concern basis) also be considered? In addition, questions regarding the volume and the nature of an insurance company's business, the time horizon to be adopted, and the acceptable probability of becoming insolvent should be considered.

**Stress testing:** Method of solvency assessment that considers the impact (current and prospective) of a defined set of alternative assumptions or outcomes that are adverse. Consideration is given to the effect of a defined adverse scenario on the insurance company’s assets, liabilities, and operations.

**Substantive procedures:** Audit procedures performed to detect material misstatements at the assertion level, including (a) tests of details of classes of transactions, account balances, and disclosures and (b) substantive analytical procedures (IFAC).

**Technical provision:** Amount set aside on the balance sheet to meet liabilities arising from insurance contracts, including provision for claims (whether reported or not), provision for unearned premiums, provision for unexpired risks, provision for life assurance, and other liabilities related to life insurance contracts (for example, premium deposits, savings accumulated over the term of with-profit policies).

**Tests of control:** Tests performed to obtain audit evidence about the operating effectiveness of controls in preventing—or detecting and correcting—material misstatements at the assertion level (IFAC).

**Exercises**

1. **Regarding the onsite inspections conducted by your supervisory authority, which inspection activities would you describe as compliance assessment in nature? Process assessment? Risk focused?**

2. **Provide an example of an onsite inspection conducted by you (or others within your supervisory authority) that led to the detection and correction of a problem that could not have been detected through offsite analysis.**
B. The onsite inspection program

As discussed in section A, onsite inspections can play many roles in the supervisory process. Accordingly, it is not unusual for a majority of the staff of a supervisory authority to be involved in onsite inspection activities. It is essential that such a significant part of the work of the supervisory authority be well organized and managed. This will ensure that supervisory resources are used effectively and efficiently in the achievement of supervisory objectives.

Planning the inspection program

Planning an onsite inspection program can be a complicated exercise. Inspection needs must be identified. The most appropriate types of inspections to meet these needs must be determined. The resources needed to carry out these inspections must be estimated. The resources available to carry out the inspections must be identified. In order to deal with any shortfall of resources, inspection priorities must be established. Taking all of these factors into account, a plan for the inspection program can be mapped out. Since the inspection program is almost certain to be affected by unexpected events, findings, and calls on resources, the plan should incorporate some flexibility. Each of these factors is considered in turn.

Typically, the budgets of supervisory authorities are established annually. Accordingly, operational plans are often prepared annually, although many supervisory authorities map out their plans for major activities over a longer period, such as three years. In any case, supervisory authorities commonly take a comprehensive look at the onsite inspection program at least annually.

Inspection needs

Neither ICP 13 nor the Supervisory Standard on Onsite Inspections (IAIS 1998) specifies the frequency with which inspections should occur. Nevertheless, certain factors may dictate the need to inspect an insurer. In some jurisdictions, legislation specifies the minimum frequency with which an inspection must occur—for example, annually. An insurer may have recently received a license to operate in the jurisdiction, and an initial onsite inspection may be needed to ensure that the insurer is conforming to the licensing conditions and operating in accordance with its business plan. Some jurisdictions require that an insurer’s license be renewed periodically, and the supervisory authority may need to perform an onsite inspection as part of the renewal process. The insurer may be part of an insurance group or a financial conglomerate, and the supervisory authority may have indicated to the home supervisor of the group that an inspection will
be performed. The previous onsite inspection of the insurer may have identified various areas of concern that warrant further investigation.

Although the inspections required to satisfy the foregoing needs form the foundation of the inventory of inspection needs, many other inspections may be warranted. Even where legislation does not require it, many supervisory authorities have established a tradition of inspecting each insurer regularly. In some cases, each insurer is inspected annually or biannually. In other cases, the frequency may vary somewhat, considering factors such as the size and nature of the insurer’s operations, the level of the insurer’s available solvency, the risk rating assigned to the insurer by the supervisory authority, and the extent to which the supervisory authority is prepared to rely on the work of others, such as an insurer’s auditor and actuary. For example, small insurers with high levels of available solvency might be inspected once every two or three years, while large insurers with complex operations might be inspected annually.

As part of the planning process, the supervisory authority should consider both the situation with respect to each insurer and developments in the market as a whole. Both the findings of previous onsite inspections of an insurer and the results of offsite analysis of its financial situation and business activities may indicate that an onsite inspection is needed. Systematic market analysis conducted by the supervisory authority, along with brainstorming sessions among supervisory staff, can identify emerging risks and issues that may affect some or all insurers.

### Inspection Approaches

After completing this analysis, the inventory of possible onsite inspections may be extensive. The resources required to perform a full-scale onsite inspection to deal with each of these possibilities would likely far exceed the resources available to the supervisory authority. Fortunately, a full-scale inspection may not be necessary, or even desirable, in every situation.

Some needs may best be met through a focused inspection of specific significant activities of a particular insurer. In other cases, a cross-sector analysis of an issue—for example, involving focused inspections of the manner in which insurers underwriting a particular type of product are managing the risks inherent in the product—may be the most effective approach.

In some cases—for example, the initial inspection of a new insurer—a high-level checklist approach may be most appropriate. Such an approach would involve a fairly quick look at all aspects of the insurer’s operations, designed to identify areas that may require a more substantive inspection. In other cases—for example, where the supervisory authority has concerns about the reliability of an insurer’s financial statements and financial regulatory returns and the sufficiency of its technical provisions—an intensive examination may be required, perhaps involving the use of external specialists.
The supervisory authority will need to consider which onsite inspection approach is best suited to each situation.

**ESTIMATING RESOURCE NEEDS**

Even with the efficiencies that can be achieved through the use of focused inspections, the resources needed may exceed those available. In order to determine if this is the case, the supervisory authority must estimate the resources needed to carry out the possible inspections that have been identified. If it is obvious that there will be a shortfall of resources, it may be appropriate to prioritize the inspection needs at this stage and prepare more detailed estimates only for the highest-priority inspections. However, it may still be worthwhile to prepare rough estimates even for the lower-priority inspections, as such estimates can support efforts to obtain additional resources.

In a large supervisory authority that has been conducting various types of onsite inspections for many years, management may fairly easily be able to prepare reasonable estimates of the types of staff that will need to be involved in each inspection and the number of days of work that will be required of each person at each stage of the inspection. Otherwise, the scope of each possible inspection should be detailed, at least on a preliminary basis, as part of the annual planning process. The tasks involved in the inspection would be identified, and the resources needed to carry out each task would be estimated.

Nevertheless, it is impossible to estimate resource needs with certainty. An onsite inspection may uncover significant concerns, which could create an urgent need to extend the inspection into other areas of the insurer or to explore issues in greater depth than originally planned. An insurer that seemed problem-free when the annual inspection plan was developed, and for which no inspection was planned at all, could report significant unexplained losses at mid-year, warranting an inspection. A supervisory authority should consider the possibility of such unidentified needs in its plans.

**IDENTIFYING AVAILABLE RESOURCES**

A variety of resources may be used to perform onsite inspections. Many supervisory authorities are organized so that a specific department works solely on onsite inspections. Most of the staff time in such a department will be available for onsite inspections. However, in the planning process, allowance must be made for time that the staff will spend on holidays, illness, training, administration, and other activities. In some supervisory authorities, the same staff that conduct onsite inspections also perform offsite monitoring and analysis. In such cases, the portion of their time available for onsite inspection work will need to be estimated. Since both inspection work and other activities will probably not be spread evenly over the year, resource estimates should be
done by month or at least by quarter. Some supervisory authorities also make allowance for an expected level of staff turnover—for example, assuming that vacant positions will take some time to fill and that new staff members will initially be less efficient than the experienced staff they are replacing.

Even in supervisory authorities where there is a specific onsite inspection department, staff from other departments may be available to participate in, or even lead, onsite inspections. For example, some supervisory authorities have individuals or departments that specialize in matters such as actuarial, accounting, compliance, technology risk, and investments. In such cases, some or all of the time of these specialists may be available for onsite inspections.

Supervisory authorities may also outsource some of their work or use external specialists, and such resources might be involved in onsite inspections. ICP 13 (essential criterion b) and ICP 3 on the supervisory authority (essential criteria r, s, and u) deal with this topic, highlighting the need to ensure that such resources are competent, are independent of the insurers, and maintain confidentiality. Examples of the ways in which some supervisory authorities use external resources include retaining auditors to inspect internal controls and verify the information contained in financial regulatory returns; contracting retired investment executives to inspect investment policies, procedures, controls, and adherence to them; and retaining actuaries to evaluate the sufficiency of technical provisions. If the supervisory authority has both the power and the funds to retain external resources, their availability should be considered during the planning process.

**Putting it all together**

Armed with information regarding possible inspections, the resources needed to perform such inspections, and the resources available to perform them, the supervisory authority is in a position to put this information together into a preliminary plan for the year’s inspection program. Table 1 provides a summarized and highly simplified example of how this might look.

In this example, it is evident that the available resources will be insufficient to meet all of the inspection needs that have been identified. The shortfall will be particularly acute in the second half of the year. Management of the supervisory authority has two basic alternatives for dealing with this situation and arriving at an achievable plan: (a) reduce the resources needed or (b) increase the resources available.

A common approach to reducing the resources needed is to prioritize the inspection activities, deferring the lower-priority inspections to the following year. This may be the most appropriate alternative, if it is legally possible to do so, if the deferral of the inspections does not significantly increase the risk to policyholders, and if the shortfall in resources is expected to disappear in the following year. Alternatively, it may be
possible to reduce the resource needs by changing some of the full-scale inspections to focused inspections.

The most obvious way to increase the resources available is to hire additional staff. Of course, due to budgetary and other constraints, this may not be possible. Alternatively, it may be possible to reprioritize work within the supervisory authority to free up more staff time for onsite inspections. Particularly if the shortfall is expected to be temporary, an appropriate solution may be to retain external assistance.

One way or another, the plan must be brought into balance and the work of performing onsite inspections begun. However, as previously noted, it is unlikely that everything will go exactly as planned. Therefore, it is important that the plan be reviewed periodically during the year, for example, monthly or quarterly. Adjustments can then be made to take account of factors such as emerging risks, changes in staff levels, the need for additional work in response to inspection findings, and so forth. It makes little sense, for example, to adhere strictly to an inspection plan that provides for routine inspections of several small, low-risk insurers when significant concerns about a major insurer arise partway through the year that make an immediate inspection imperative.

Table 1. Preliminary annual inspection plan

<table>
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<tr>
<th>Resources</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
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<td></td>
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<td></td>
<td></td>
<td></td>
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<td>2</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
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<td>6</td>
<td>4</td>
<td>10</td>
<td>24</td>
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<tr>
<td>Total resources needed</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
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<td>6</td>
<td>8</td>
<td>10</td>
<td>12</td>
<td>36</td>
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<td>28</td>
<td>31</td>
<td>96</td>
</tr>
<tr>
<td>Resources available (person/weeks)</td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
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<td>10</td>
<td>8</td>
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<td>20</td>
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<td>20</td>
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<td></td>
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<tr>
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<td>2</td>
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<td>(4)</td>
<td>0</td>
</tr>
<tr>
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<td>(1)</td>
<td>(10)</td>
<td>(11)</td>
<td>(22)</td>
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**Full-scale inspections**

A full-scale onsite inspection is a wide-ranging look at the finances and operations of an insurer. It can greatly assist the supervisory authority in arriving at a comprehensive assessment of the insurer’s risk profile, viability, and compliance with requirements. Explanatory note 13.5 to ICP 13 indicates that a full-scale inspection should include, at a minimum, the following activities:

- Evaluation of the management and internal control system
- Analysis of the nature of the insurer’s activities, such as the type of business written
- Evaluation of the technical conduct of insurance business or evaluation of the organization and management of the insurer, the commercial policy, and the reinsurance cover and its security
- Analysis of the relationships with external entities, such as through outsourcing or with respect to other companies in the same group
- Assessment of the insurer’s financial strength, notably the technical provisions
- Evaluation of compliance with corporate governance requirements.

Paragraph 18 of the *Supervisory Standard on Onsite Inspections* (IAIS 1998) describes various more detailed steps that should be taken to accomplish each of the parts of a full-scale inspection. For example, assessment of an insurer’s financial strength would involve the following:

- Analysis of the settlement of claims and calculation of the technical provisions according to current regulations
- Analysis of the adequacy of tariffs and the balance of operations
- Analysis of the investment policy (including derivatives policy) and the assets held to cover the technical provisions
- Verification of property and valuation of the investments
- Analysis of the litigation and off-balance-sheet commitments
- Analysis of the forecasted balance sheets and profit and loss accounts for the next two or three years, on the basis of the most recent results and management plans.

A full-scale onsite inspection can require a significant expenditure of supervisory resources, particularly for a large or complex insurer. An in-depth analysis of each of the areas covered by a full-scale inspection might keep supervisory staff on site for a long time. Accordingly, supervisory methods have been developed to enable full-scale inspections to be conducted efficiently, without unduly compromising their effectiveness. (At a detailed level, as mentioned previously, sampling is used to provide a comprehensive picture without having to review every transaction, calculation, or document.)
One approach is to address all of the areas of a full-scale inspection each year, but to select certain areas that will be covered in depth in a particular year and deal with others at a higher level. For example, corporate governance and relationships with external entities may be covered in depth one year, but only at a higher level the next year. Conversely, investments and technical provisions may be covered at a higher level the first year and in greater depth the next year. Those areas covered at a higher level may, for example, be dealt with through the use of checklists or by updating the more detailed work done in a previous year. The selection of areas that will be inspected in depth in a particular year may be influenced by the results of previous inspections, off-site analysis of an insurer's risk profile, industry trends, or other factors.

A related approach is to spread some of the work of a full-scale inspection over a period of years. For example, if a large insurer operates three major categories of business, the aspects of a full-scale inspection relating specifically to one of these major categories of business might be dealt with in depth each year, with a higher-level review performed during the other years. Aspects of a full-scale inspection that relate to the insurer as a whole would be covered every year.

A disadvantage of approaches that do not cover each aspect of a full-scale, in-depth review as a part of each inspection is that they increase the risk that the overall supervisory assessment will be compromised by the inclusion of incomplete or outdated information. This risk can be reduced by carefully monitoring those areas that are not being inspected in depth during a particular inspection, in order to identify changes that may be significant. The files of the supervisory authority should clearly indicate the areas that were inspected in depth and those that were not. It might also be useful to communicate this information in the final inspection report.

Some of the activities involved in an inspection, including a full-scale inspection, can often be done, at least in part, off site. For example, the report of the insurer’s actuary might be read and analyzed, and quantitative tests performed on the technical provisions, before going on site. Such analysis can help both to limit the time spent on site and to make that time more productive, by focusing the onsite work on specific areas of concern.

Focused inspections

It is often impractical to examine each aspect of an insurer in depth as part of a full-scale inspection. Attempting to do so would likely be an inefficient use of supervisory resources. However, there are circumstances in which it is essential to examine particular aspects of an insurer's operations in detail. In such circumstances, a focused inspection should be performed.

Focused inspections are frequently performed in response to specific supervisory concerns about a particular insurer. For example, if a high-level inspection indicates that an insurer's controls over its claims-handling and provisioning processes appear to
be weak, a focused inspection of those areas can confirm these suspicions and provide a more solid basis for requiring corrective measures. Concerns that arise from offsite monitoring and analysis might also trigger a focused inspection, for example, of market conduct or investment management.

In situations where an insurer has been required to take actions to deal with supervisory concerns, a focused inspection may be performed in order to confirm that the agreed actions have been taken and were effective.

Focused inspections might also be performed in order to take a close look at a particular aspect of an insurer’s operations, even when there is no particular reason to suspect that a problem may exist. For example, consider the following scenarios. In the first scenario, an insurer has recently been acquired by a financial conglomerate. The supervisory authority performs a focused inspection to achieve an in-depth understanding of how the change in ownership has affected the corporate governance processes of the insurer. In the second scenario, an insurer has achieved significant premium growth in a particular class of business that has different risk characteristics than its traditional classes of business. A focused inspection is conducted to assess the insurer’s understanding of the risks and the effectiveness of its risk management processes.

Focused inspections can also be used to help the supervisory authority to identify and understand issues that may affect many insurers. For example, focused inspections might be conducted of the derivatives operations of each insurer that is active in this area. The inspections can provide a better understanding of the derivative products being used by the insurers, how each insurer is using them, and the risk management practices that are being used. The analysis of inspection findings may highlight industry-wide risks, be useful in establishing best-practice benchmarks in risk management, and identify insurers whose risk management practices are inadequate.

**Market conduct inspections**

So far, our discussions of onsite inspections have focused on inspections conducted for the purposes of prudential supervision—in other words, inspections designed to evaluate an insurer’s ability to meet its obligations to consumers. However, the fact that an insurer is financially strong is of little value to a policyholder if the insurer, or the intermediary, fails to deal fairly with the policyholder. The markets and consumers section of the ICPs—ICPs 24–27—set out principles and criteria directed toward ensuring appropriate market conduct. Onsite inspections of market conduct are essential in assessing whether insurers and intermediaries are conducting themselves appropriately in their dealings with consumers.

Explanatory note 13.6 to ICP 13 indicates that a full-scale inspection of market conduct should include, at a minimum, the following activities:

- Checking the sufficiency and adequacy of the information given to consumers
- Reviewing the timing of payments
- Reviewing the frequency and nature of litigation
- Assessing the observance of market conduct standards and consumer regulations.

The factors considered in designing an onsite inspection program for prudential purposes also apply in the case of market conduct inspections. Market conduct inspections may be directed at assessing compliance or controls, be risk focused, or use a combination of these approaches; they may be full scale or focused in scope; priorities must be established; sampling techniques can be used; and so forth. However, some additional factors should be considered, and these are discussed below.

The need for a market conduct inspection may be identified as a result of formal complaints by consumers or informal market intelligence. This makes it more difficult to identify specific inspections in the annual plan and highlights the need for flexibility in order to respond to emerging concerns.

Also, in situations where serious misconduct is suspected, such as misappropriation of policyholders’ funds by an intermediary, it may be important to conduct an inspection without prior notice to the party being inspected. Such an approach can mitigate the risk that records will be altered or destroyed.

For practical reasons, it is sometimes appropriate when inspecting the activities of intermediaries to start with an insurer’s procedures and controls for dealing with intermediaries. If such an inspection identifies weaknesses, this information may be useful in determining the focus of inspections of the intermediaries themselves. For example, an inspection of the insurer may reveal weaknesses in its controls regarding the collection of premiums from brokers. Inspections of brokers that deal with this insurer might then focus on whether the brokers are properly accounting for clients’ funds and segregating such funds from their own working capital.

In some jurisdictions, as mentioned in section A, market conduct supervision and prudential supervision are the responsibility of different authorities. Thus some supervisory authorities might not perform market conduct inspections. However, the linkage between market conduct and prudential matters should be kept in mind. For example, complaints about slow and unfair claims payment practices may indicate that an insurer has inadequate liquidity or insufficient technical provisions. Misselling of insurance products can result in legal judgments that would compromise an insurer’s solvency. Therefore, communication between those responsible for prudential supervision and those responsible for market conduct supervision is essential, whether these functions are handled by the same or by separate supervisory authorities in a particular jurisdiction.

Onsite inspections are also relevant in the supervision of the efforts of insurers and intermediaries to combat money laundering and the financing of terrorism. The module on ICP 28 discusses the activities that might be included in such inspections.
Reliance on the work of others

The section on identifying available resources discussed the use of external parties to perform or assist with onsite inspections. However, the work of various parties outside the supervisory authority can also be relevant to the onsite inspection program, even if such work was not performed as part of an onsite inspection or to meet the specific needs of the supervisory authority (see Savage 1998, pp. 14–15).

In most, if not all, jurisdictions, the annual financial statements of an insurer must be audited by an auditor that is independent of the insurer. The external auditor provides a written opinion on whether the financial statements have been prepared in accordance with the relevant accounting standards and whether they fairly represent the insurer's financial situation. In order to provide such an opinion, the auditor evaluates the data, processes, and controls that are relevant to the reliability of the insurer's financial statements. Since most financial statements are prepared on the assumption that the company is a going concern, the auditor will also need to consider the basic viability of the insurer before rendering an opinion on the financial statements. For more information on the work of the external auditor, refer to the *Handbook of International Auditing, Assurance, and Ethics Pronouncements* (IFAC 2006).

Insurers often have an internal audit function, charged with evaluating and monitoring the adequacy and effectiveness of internal controls and risk management processes. While the work of external auditors focuses on financial reporting, the work of internal auditors considers other controls as well. For example, an internal audit may examine the policies, procedures, and controls related to the underwriting of property insurance risks. Internal auditing may be performed either by staff of the insurer who are independent of operational management or by external consultants.

In many jurisdictions, the liabilities of an insurer must be valued by an actuary. In some of these jurisdictions, the actuary has formal responsibilities under the legislation (see IAIS 2003b). For example, the actuary may be required to prepare a report for the board of directors and the supervisory authority that describes the data, methods, and assumptions used in calculating the technical provisions and includes the actuary's opinion regarding their sufficiency. The actuary may also be required to perform stress tests to assess the impact of adverse scenarios on the insurer's current and future financial position (see IAIS 2003a).

Clearly, the work of external auditors, internal auditors, and actuaries is of interest to a supervisory authority. At a minimum, the supervisory authority should review their reports as part of its offsite monitoring and investigate any significant areas of concern that arise from such monitoring. Regular communication with such parties can provide the supervisory authority with further input on issues that may require supervisory review.

If the supervisory authority has confidence in the work of others, the ability to rely on their work can affect the nature of the onsite inspection program. For example, if the external auditor has conducted a detailed review of an insurer's investment controls
and asset valuation methods, the supervisory authority may need to do little work in this area during the onsite inspection. However, some supervisory authorities, as a matter of principle, perform inspections on key aspects of an insurer’s financial statements independent of the work carried out by the external auditor.

Of course, the supervisory authority cannot rely on the work of others solely on faith. Their work should always be subject to review by the supervisory authority. Analysis of the relevant reports and communication with these parties can help the supervisory authority to assess their capabilities and the scope and quality of their work. The ability to rely on the work of others is enhanced when the work is performed in accordance with strong professional standards and the professions are well governed.

When the supervisory authority is relying on the work of others, it must have access to the parameters governing such work. The supervisory authority must have a clear understanding of how the work was performed and the basis of the conclusions presented, so that it can develop an informed and independent opinion on the issues.

In some jurisdictions or with respect to some insurers, the supervisory authority may have concerns about the scope or quality of the work done by the auditors or actuaries, or such professionals may simply not be in place. In such situations, the onsite inspection program may need to allow for more extensive work by the supervisory authority. The supervisory authority might also require independent external analysis of areas of concern, perhaps at the expense of the insurer.

### Exercises

3. Describe the processes used by your supervisory authority to plan the inspection program, monitor progress against the plan, and revise the plan during the year.

4. Identify any circumstances in which the legislation in your jurisdiction would require an onsite inspection. Beyond the legal requirements, what factors are used by your supervisory authority to determine how frequently an onsite inspection of an insurer will be performed?

5. Prepare a rough estimate of the resources used last year by your supervisory authority to perform onsite inspections, according to the following categories: (a) staff whose primary responsibilities are onsite inspections (person/years), (b) staff whose primary responsibilities are in other areas (person/years), and (c) external resources (person/years or financial cost).

6. Provide an example of a focused inspection that was performed recently by your supervisory authority.

7. Explain how your supervisory authority uses the work of others, such as external auditors, internal auditors, and actuaries. Provide an example of a situation where such work influenced the scope of an onsite inspection.
C. Performing an onsite inspection

Section B discussed the development of plans for the onsite inspection program as a whole. This section discusses, in turn, each of the main steps involved in performing a particular onsite inspection: planning and preparation; fieldwork and documentation; assessment and reporting; and follow-up.

Ordinarily, one person is assigned overall responsibility for a particular inspection. In this module, this person is referred to as the team leader. The approaches to assigning responsibility for team leadership vary from one supervisory authority to another and may even vary within a particular authority according to the nature of the inspection. For example, the supervisor who has overall responsibility for the supervisory authority's relationship with a particular insurer may take the lead in full-scale inspections of that insurer. However, a focused inspection of the insurer's technical provisions may be led by one of the supervisory authority's actuaries. Regardless of how the team leader is determined, it is important that such assignment be made. The designation of a team leader facilitates communication both within the supervisory authority and between the authority and the insurer. The team leader should be accountable for ensuring that an inspection is planned and executed properly.

Planning and preparation

Careful planning and preparation can contribute significantly to the effectiveness and efficiency of an onsite inspection. They enable the inspectors to focus on the areas of highest priority, ask relevant questions, complete their work in a timely manner, and minimize any disruptions to the insurer's operations. Conversely, inadequate planning and preparation can result in the ineffective use of valuable onsite time, damage the reputation of the supervisory authority, and unnecessarily impose on the staff of the insurer.

Establishing Priorities

The first step in planning is to establish priorities for the various areas to be inspected. Even in a full-scale inspection, it is usually appropriate to give certain areas more attention than others. Priorities can be established in much the same way as for the inspection program as a whole. The results of previous inspections of the insurer, the results of offsite monitoring and analysis (see ICP 12), the supervisory authority's rating of the risks inherent in various activities of the insurer, and developments in the market should all be considered. The team leader typically consults with others in establishing the priorities—for example, team members, the leaders of other teams, and superiors.
**DEFINING SCOPE**

The second step is to define the nature and scope of the inspection that will be performed in each of the areas to be inspected. As mentioned in section A, supervisory approaches may be broadly characterized as compliance assessment, process assessment, or risk focused in nature. The nature of the inspection activities required may vary according to the basic supervisory approach. For example, a compliance assessment approach is likely to involve substantive tests of transactions while on site. A process assessment approach is likely to focus more on tests of control. The inspection activities that will be carried out should be detailed, and the skills necessary to carry out the various inspection activities should be identified.

The time that will be spent on each activity should be budgeted, and a detailed time line prepared. The time line should encompass all steps of the inspection, including preparatory work, fieldwork, documentation, and reporting. While many factors will affect the amount of time spent in the field, it is not unusual for a full-scale inspection of a small insurer to involve two weeks of fieldwork by a team of three or four supervisors.

**FORMING THE TEAM**

The third step is to secure individuals with the necessary expertise for the inspection team. In practice, this may present a significant challenge. For example, the team members may already have been assigned, and some of them may be less experienced than would be ideal. If a highly technical aspect of the insurer’s operation is to be inspected, special knowledge or experience may be required—for example, regarding products, software tools, or back-testing processes. Perhaps there is no one on staff with the expertise necessary to understand the entire scope of inherent risks or to assess whether the risks are being managed adequately. The team leader will need to overcome such obstacles—for example, by allocating inspection responsibilities to make the best possible use of the persons available, by borrowing persons with the necessary skills from other teams or departments within the supervisory authority, or by seeking external expertise. In the end, the inspection plan may need to be revised in order to reflect the resources that are actually available.

**IDENTIFYING INFORMATION NEEDED**

The fourth step is to identify the additional information that will be needed to prepare for the inspection. The supervisory authority will often have a considerable amount of information about the insurer that can be used in preparing for an inspection. For example, it may have files from the previous inspections, financial statements, financial and nonfinancial regulatory returns, business plans, organizational charts, supervisory
analyses of the insurer’s risk profile, and so forth. Nevertheless, an onsite inspection is intended to elicit information that is not already in the supervisory authority’s files, and some of this information might usefully be requested of the insurer before the team goes into the field.

The types of information that might be requested in advance include information that will take some time for the insurer to compile, require extensive analysis by the supervisors, or be useful in focusing the fieldwork. An example of information in the first category might be a special report detailing the insurer’s investments by type of investment, industry classification, and geographic territory. The second category might include the electronic data files used by the insurer in calculating its motor vehicle insurance claims provisions. The third category might include a detailed questionnaire regarding various aspects of an insurer’s information technology systems and controls. This category could include reports regularly prepared by the insurer for its management and board that cover the areas to be inspected. Such reports may be structured differently than the regulatory returns and can provide a lot of useful information about the insurer and the aspects of its operations that it considers important.

However, some types of information are best obtained in the field. For example, an inspection of claims handling may require the review of a sample of claims files. It would be costly and inconvenient for an insurer to send copies of these files to the supervisory authority in advance, sending such information outside the insurer’s offices may heighten concerns about the possible breach of customer confidentiality, and the supervisory authority could end up buried in paper! Information that is subjective in nature, or open to varying interpretations, might also best be gathered while on site—for example, through meetings with the appropriate persons.

**Communicating with the Insurer**

At some point, the supervisory authority needs to communicate with the insurer about the inspection plans. In most cases, it is best for both the supervisory authority and the insurer to initiate such communication well in advance of the fieldwork. This enables the insurer to take the inspection into account in planning its own activities and gives it time to prepare any additional information requested by the supervisory authority. With advance notice, the insurer should be able to ensure that relevant members of its staff are available to meet with the supervisors when they are on site. Sometimes—for example, when a focused inspection is being conducted in response to a serious concern that has recently arisen—the time for planning and preparation may be quite limited, and little advance notice will be possible. In other situations, even if the supervisory authority has plenty of time to plan and prepare for the inspection, it may be appropriate to have little or no advance communication with the insurer. For example, if serious breaches of legislation are suspected, a surprise inspection may be essential in order to prevent the insurer from destroying or altering incriminating documents. Also, if the
supervisory authority has reason to believe that an insurer may delay the production of documents until late in the inspection—in order to limit the time available for supervisory review—the authority may decide not to communicate a fixed deadline by which it intends to complete the inspection.

**Preparatory work**

Preparatory work includes reviewing and analyzing the information available, both existing information and information that has been provided by the insurer in response to the pre-inspection request. Some of the information may be subjected to quantitative or statistical analysis, with the results highlighting areas for further investigation while on site. Some of the information may be analyzed in order to identify the sample of transactions or files that will be reviewed on site, which will not necessarily be a random sample. (For information on sampling, see IFAC n.d.) Qualitative information, such as business plans and the minutes of board meetings, can be reviewed in order to identify areas for discussion with management.

Many supervisory authorities have developed checklists, assessment criteria, and questionnaires that can be used to gather information while on site. (As examples, see NAIC various years; OSFI 2002.) Consistent with ICP 4, which requires that a supervisory authority conduct its functions in a transparent and accountable manner, many supervisory authorities have published information about their assessment tools and processes—for example, on their websites. International organizations have also published various papers that can guide the collection of relevant information (for examples, see Basel Committee 1998; IAIS 2000a, 2000b, 2002, 2004; Joint Forum 1999; and OECD 2004.) Since it is both impossible and undesirable to specify all supervisory criteria in legislation, access to such information can help industry to understand and meet supervisory expectations. Preparatory work includes selecting the most relevant tools, modifying them as necessary to meet the needs of the particular inspection, and supplementing them with questions that have arisen from the analytical work.

**Fieldwork and documentation**

Fieldwork is the core of the onsite inspection process. The manner in which the fieldwork is conducted will also influence the effectiveness of an onsite inspection. During its time in the field, an inspection team should efficiently gather the information needed to meet the objectives of the inspection. The information that is gathered should be documented carefully in order to facilitate further analysis and support any conclusions and recommendations that arise from the inspection.
OPENING MEETING

Good communication with the insurer's management and staff can contribute significantly to the effectiveness of the fieldwork. One technique commonly used to promote good communication is to hold an opening meeting at the beginning of the fieldwork. In such a meeting, the team leader and members can meet the key individuals with whom they will be dealing during the inspection and clarify the specific responsibilities of each. The scope and objectives of the inspection can be reviewed and reinforced, and the various activities that will be carried out can be described. A schedule of working sessions involving specific team members and staff of the insurer, in connection with the various inspection activities, can be prepared or confirmed.

MANAGING THE FIELDWORK

The team leader is responsible for managing the fieldwork. This involves monitoring the work of the inspection team, including any consultants or representatives of other supervisory authorities that may be participating, in order to ensure that the planned inspection activities are completed properly and on schedule. If any of the activities are not going according to plan, the team leader needs to act promptly. Actions may include, for example, reallocating responsibilities among team members, providing coaching, obtaining additional resources, or adjusting the inspection plan.

It is useful for the inspection team to meet regularly throughout the course of the inspection. Such meetings need not be lengthy. They can provide an excellent means of tracking the progress of the fieldwork. They can also serve as a forum for airing any operational issues that may be impeding the inspection, such as uncooperative behavior on the part of the insurer's staff. The team leader can seek resolution by discussing such concerns with the appropriate managers of the insurer and, if necessary, management of the supervisory authority. Team meetings also facilitate the sharing of preliminary findings, which may indicate a need to adjust the work plan—for example, to carry out further investigation of a newly identified area of concern.

INSPECTION ACTIVITIES

The inspection plan may include a range of activities to be used in gathering information about the insurer's financial condition and operations. Some of these activities were mentioned in the discussion of the planning and preparation stages. For example, the checklists, assessment criteria, and questions that were prepared before going into the field are put to use. Relevant members of the insurer's management and staff are interviewed to obtain some of the required information. When conducting such interviews, supervisors should, of course, be polite and respectful, but this does not mean that they
should accept everything they are told! The information provided should be evaluated critically. Clarifications should be sought and inconsistencies probed, to the extent necessary to get a clear and complete answer to the supervisor's query. Open-ended questions are often more effective in eliciting information than close-ended questions, such as those that can be answered yes or no.

Some types of information might be obtained by reviewing written or electronic documents, such as minutes, reports to management, quantitative reports, corporate policies, and procedure manuals. Other types of information might be gained through the analysis of detailed records, such as policy master files, claim files, investment files, and actuarial valuation files.

It is essential that the supervisors have access to all information relevant to their inspection. For example, if an insurer has outsourced important business functions, it may be necessary to extend the fieldwork to include the service provider in order to obtain the necessary data or test the insurer's control over outsourced activities (see OSFI 2003). If staff or management of an insurer impedes supervisors' access to information, the team leader should immediately seek to resolve the situation. Resolution may require involving senior management of the supervisory authority and even the insurer's board of directors. In most jurisdictions, legislation provides that the failure to provide information required by a supervisor is a punishable offence. The fact that access is being impeded should, in itself, alert the supervisor to the need for a closer look at the area under investigation.

Substantive procedures are one common type of inspection activity. External auditors typically perform substantive procedures to detect material misstatements of financial information. However, supervisory authorities might apply them to a broader range of investigation—for example, to identify noncompliance with legal requirements or an insurer's internal policies. Substantive procedures would include tests of the details of various classes of transactions, account balances, and disclosures. They might also include analytical procedures—for example, using computer software tools to analyze claim payment data in order to identify improper or inaccurately recorded payments.

Tests of control are another common type of inspection activity. Tests of control are performed to obtain evidence about the operating effectiveness of controls. External auditors would focus on testing the effectiveness of controls in preventing, or detecting and correcting, material misstatements of financial information. Once again, supervisory authorities might apply such tests more broadly. For example, the policies and procedures governing the investment process might be reviewed with the objective of identifying weaknesses. Investment transactions might then be analyzed to evaluate whether the procedures and controls, even if they appear sound on paper, are applied successfully in practice to ensure that investment activities are carried out in accordance with the insurer's investment policy. It is essential that the quality of internal auditing be assessed when evaluating an insurer's control environment. The quality of the internal audit function depends on such factors as its mandate, independence from operational management, staffing levels and capabilities, and work program.
The distinction between substantive procedures and tests of control is subtle. Substantive procedures are designed to detect actual problems with the underlying information or transactions, while tests of control are designed to evaluate the extent to which an insurer’s controls can be relied on to keep such problems from existing.

Many factors may influence the decision about whether to emphasize substantive procedures or tests of control in an onsite inspection. If an insurer’s controls are generally weak, management has in the past failed to enforce the observance of controls, or the scope or quality of internal and external auditing is inadequate, substantive procedures are required. However, if an insurer’s controls are generally adequate, controls are typically observed by the insurer’s staff, and internal and external auditing is adequate, supervisory resources might best be devoted to tests of control. In practice, the situation may not be clear-cut, in which case both techniques might be used to some extent.

Regardless of the techniques used, a few fundamental principles should be considered when carrying out inspection activities. The first of these is the principle of proportionality, which means that the resources devoted to pursuing an area of investigation should be proportional to the importance of that area to the overall assessment of the insurer. The second is the principle of context, which means that the characteristics of the insurer and its operations are relevant to the nature and extent of the inspection activities. For example, the inspection of a large insurer with well-documented procedures and a capable internal audit function should differ from that of a small insurer with less-developed control mechanisms. The third is the principle of risk, which means that the supervisor’s perception of the risks faced by the insurer should guide the inspection activities. Even if an inspection is being performed to assess compliance with legislation, more attention might be devoted to areas in which noncompliance would pose the greatest risk to an insurer or its policyholders. For example, if an insurer is a member of a financial conglomerate, the inspection may focus on tests of control regarding transactions with related parties.

**Case Study. Inspection of Claims Management and Claims Provisions**

Motor Insurer is a small, domestic non-life insurance company that underwrites only motor vehicle insurance. Although Motor Insurer has generally been unprofitable in recent years, it reported a profit last year. However, offsite analysis reveals that this profit was accompanied by a significant decrease in the ratio of claims provisions to claims paid during the year. The supervisory authority has received a disproportionately high number of complaints from the public about delays in payments or unfair settlements on the part of Motor Insurer.

The supervisory authority suspects that Motor Insurer has achieved the appearance of profitability by treating its claimants unfairly—paying them too little or too slowly—and understating its claims provisions. In order to better assess the situation and, if its suspicions are confirmed, support supervisory intervention, the supervisory authority has decided to perform a focused onsite in-
Case Study (continued)

The scope of the inspection will include both claims management and claims provisioning.

The supervisory authority has decided to use the *OECD Guidelines for Good Practice for Insurance Claim Management* (see OECD 2004) as the basis for its inspection of claims management practices and controls. The inspection of claims provisioning will encompass the data, methods, assumptions, and controls related to the calculation and analysis of claims provisions by the insurer. Accordingly, the elements that it will take into account, the information that it will request in preparation for the inspection, and the activities that it will undertake in the field are summarized as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Element of the inspection</th>
<th>Information requested and preparatory work</th>
<th>Field activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Review of nonconfidential claims data for open and closed files of the current year and the two preceding years</td>
<td>Electronic claims data files; analyze to select sample of claim files to be reviewed in the field</td>
<td>Substantive testing of accuracy of records and consistency of electronic and paper records</td>
</tr>
<tr>
<td>2</td>
<td>Maintenance of sufficient and appropriate information on claim files</td>
<td>Elements of electronic claim files; review to assess adequacy of information maintained</td>
<td>Review adequacy of paper claim files</td>
</tr>
<tr>
<td>3</td>
<td>Use of the appropriate type of claim form for motor insurance</td>
<td>Claim form; review to assess adequacy and clarity</td>
<td>Substantive testing to confirm claim form is being used</td>
</tr>
<tr>
<td>4</td>
<td>Proper qualification of the claims department’s employees</td>
<td>Organizational chart; review to select persons to be interviewed</td>
<td>Interview selected persons to assess qualifications</td>
</tr>
<tr>
<td>5</td>
<td>Valuation of claims payments according to company procedures</td>
<td>Policies and procedures for claim adjudication; review appropriateness</td>
<td>Substantive testing to assess compliance with policies and procedures</td>
</tr>
<tr>
<td>6</td>
<td>Appropriate tracking of the nature and number of complaints related to the claim management process</td>
<td>Complaint-handling policies, procedures, and reports; review appropriateness of policies and procedures and adequacy of reports</td>
<td>Test of control to assess the handling of complaints; substantive testing to assess compliance and review fairness of treatment</td>
</tr>
<tr>
<td>7</td>
<td>Monitoring of the proportion of claims that result in litigation</td>
<td>Report containing information on claims litigated during the current year and two preceding years; calculate proportion and select files to be reviewed in the field</td>
<td>Review selected files; interview claims vice president and legal counsel</td>
</tr>
<tr>
<td>8</td>
<td>Compliance with procedures for combating fraud and money laundering</td>
<td>Procedures for combating fraud and money laundering; review adequacy</td>
<td>Test of control to assess compliance with procedures</td>
</tr>
<tr>
<td>9</td>
<td>Regular internal audit practices on claim files</td>
<td>Internal audit mandate and reports; review to assess scope and quality of the work; review findings and identify issues for discussion with internal auditors</td>
<td>Interview internal auditors</td>
</tr>
<tr>
<td>10</td>
<td>Appropriate internal claims procedure manuals</td>
<td>Procedure manuals; review to assess adequacy</td>
<td>Substantive testing to assess compliance</td>
</tr>
</tbody>
</table>
DOCUMENTING THE FINDINGS

An onsite inspection can generate a large amount of information of various types. This information should be documented carefully and organized in a manner that will make it easily accessible and useful. Appropriate documentation of inspection findings facilitates further analysis and supports any conclusions and recommendations that arise from the inspection. Conversely, poor documentation can make it very difficult to identify significant issues or support preventive or corrective measures.

Each supervisory authority should develop a documentation system that is appropriate to its circumstances. Factors to consider might include the number, size, and complexity of the insurers, the nature of the information that will be collected, the uses to which the information will be put, and the level of technology available to the supervisory authority. Many supervisory authorities organize both electronic and paper files under a hierarchical structure, such as the following: insurer, year, significant activity inspected, and type of information, such as documents collected from the insurer, responses to supervisory questionnaires, working papers, section notes on findings under each part of the inspection, reports to management of the supervisory authority, and correspondence with the insurer.

It is useful to complete the basic documentation while the fieldwork is under way. This supports preliminary analysis of the findings and helps to identify any areas in which additional information may be required. It also minimizes the chore of sorting
through and organizing material once the supervisor returns from the field. To assist in documentation of the findings, some supervisory authorities have prepared electronic versions of their questionnaires, assessment criteria, and section notes. Supervisors using portable computers can enter the information directly into these documents as it is gathered.

As the fieldwork progresses, the documentation should build from raw data to working papers and then to section notes. The findings should be reviewed and discussed by the team, providing the basis for preliminary conclusions on the results of the inspection.

CLOSING MEETING

When the inspection team has completed its fieldwork, it should have a closing meeting with relevant members of the insurer’s management. In such a meeting, the inspection activities performed can be reviewed briefly, and the most significant findings can be presented. If communication during the inspection has been good, there should be no surprises. Nevertheless, the closing meeting provides a formal opportunity for the supervisors to obtain feedback on whether management was aware of any problems identified in the inspection, agrees that the problems exist, and is prepared to deal with them.

It is essential that supervisory conclusions and actions be built, to the extent possible, on a firm foundation of factual information. The closing meeting enables management to identify factual errors or misunderstandings on the part of the supervisors and to correct them.

At the closing meeting, the team leader should explain the subsequent steps in the supervisory process and their expected timing. These steps typically include further supervisory analysis, the issuance of a formal report to the insurer, the insurer’s written response to the report, and so forth. Finally, if the insurer’s staff were cooperative with the inspectors, it would be appropriate to acknowledge this in the closing meeting.

Assessment and reporting

Simply completing the fieldwork does not mean that the work of the onsite inspection is finished. The supervisory authority must fully assess the findings, update its overall risk assessment of the insurer, determine the consequential actions that should be taken, and deal with the insurer to implement these actions.
Assessment and Internal Reporting

The inspection team generally is very busy gathering and analyzing information when it is in the field, leaving relatively little time to reflect on the findings and consider their full implications. This must be done back at the office and typically includes other staff and management of the supervisory authority.

Supervisors assess the findings in order to identify the issues of greatest concern. Such issues might include evidence of noncompliance with legislation and regulatory requirements, inadequate remediation of concerns identified in previous inspections, significant weaknesses in internal control, an imprudent approach to the conduct of business, and material misstatements in the balance sheet.

The effects of these issues on the supervisory risk assessment are considered. If the concerns are serious, they may change the overall risk rating assigned to the insurer, which, in turn, could call for specific types of preventive or corrective measures.

Based on its assessment, the supervisory authority must decide what steps should be taken, by both itself and the insurer. For example, the supervisory authority may place the insurer under closer supervision, perform an additional onsite inspection, or impose sanctions. It needs to decide what types of actions it will request—or require—of the insurer. For example, it may direct the insurer to strengthen its controls in particular areas, revalue its technical provisions using more prudent assumptions, or cease underwriting a particular class of business.

The supervisory authority should have processes in place to ensure that its assessments, and the resulting actions, are fair and consistent. For example, the team leader may be required to present the team's assessment and recommendations to the leaders of other teams, consider their input, and make appropriate revisions. A summary report on the inspection and recommendations normally is prepared for management. If the insurer is large or the findings are serious, the report may require the concurrence of the head of the supervisory authority.

Communicating with the Insurer

The supervisory authority should communicate with the insurer regarding the results of its assessment, the actions it expects the insurer to take, and any consequences to the insurer, such as sanctions. In some jurisdictions, legislation requires such communication. Even if it is not strictly required, such communication is simply good practice. It is unreasonable to expect an insurer to take steps to improve its operations or financial situation if the supervisory authority has not clearly communicated its concerns and the nature of the response it considers appropriate.

In many jurisdictions, a formal written report or letter is sent to the insurer's chief executive officer. Sometimes—for example, if required by law or if concerns are particularly serious—the letter is also sent to the insurer's board of directors. Some supervisory authorities normally meet in person with relevant members of the insurer's senior man-
agement, such as those responsible for the operations that were inspected, to present the report.

It is important that a supervisory authority focus its reports and recommendations on the issues of highest priority. This is particularly the case when dealing with directors and managers at the most senior levels. Cluttering a report with minor issues and recommendations can divert their focus from dealing with the issues of greatest concern to the supervisory authority. Minor points can be communicated, perhaps less formally, to the insurer’s operational managers.

Preparing recommendations and issuing the corresponding report or letter can take a lot of time. It can be tricky to turn findings into recommendations that convey clearly what needs to be done. Supervisors may have a clear idea of what the issues are and what should be done and can describe these verbally. However, written notes resulting from the onsite work may contain too much other information, which can cloud the key issues. It can take a lot of discussion and drafting to clarify these issues.

The report or letter should state concisely what was found, what the problems are with the findings, and what should be changed to remedy the situation. Time lines should be provided, both for responding to the supervisor’s letter and for taking action in response to the recommendations. The insurer should be required to respond in writing; in some jurisdictions, a response is required by law. The response should confirm agreement with the findings and recommendations or indicate specific areas of disagreement, and it should include action plans, with time lines, for dealing with the recommendations. If the insurer’s response is not satisfactory, the supervisory authority will need to consider taking formal corrective action or imposing sanctions. (See ICP 14 on preventive and corrective measures and ICP 15 on enforcement and sanctions, and the related modules, for more information.)

**Follow-up**

An insurer may have submitted satisfactory plans to deal with the concerns raised by the supervisory authority. Unfortunately, this does not guarantee that it will follow through and implement these plans effectively. It is therefore important for the supervisory authority to develop and implement its own plan for following up with the insurer to ensure that the necessary actions have been taken.

The nature and frequency of the supervisory follow-up will vary according to the situation. If the concerns are not serious and the insurer is generally diligent about meeting its commitments to the supervisory authority, it may be sufficient to follow up during the next regular onsite inspection. Conversely, if the supervisory concerns are serious and the insurer has a history of noncompliance, frequent follow-up may be necessary.

Follow-up activities can include periodic conversations with the insurer’s management on the telephone or in person, review of the insurer’s project status reports, and
analysis of special financial reports that the insurer may be required to submit to the supervisory authority. In some cases, a focused onsite inspection may be needed to assess whether an insurer has effectively dealt with supervisory concerns.

Finally, it is important to remember that the successful completion of an onsite inspection is not the end of the story. It is part of the ongoing process of supervision. If the inspection was successful, the same concerns should not resurface in the next inspection. However, management, products, marketing programs, market conditions, and the economy all change over time, posing new challenges with which insurers and intermediaries must cope. Onsite inspection is an essential tool that enables the supervisory authority to contribute to the insurance industry’s success in coping with these challenges, thereby safeguarding the interests of consumers.

Exercises

8. Outline the main steps followed by your supervisory authority in performing an onsite inspection, from planning to follow-up. Explain the reasons for the differences, if any, from the steps described in section C of the module.

9. Briefly describe the tools used by your supervisory authority to guide its onsite inspections, such as checklists, assessment criteria, and questionnaires. How were these tools developed? Which of them are available to industry or the public?

10. Briefly describe the approach used by your supervisory authority to document the work and results of its onsite inspections.

11. In order to perform the inspection described in the case study, for which of the items will special expertise likely be required? What types of expertise?

12. Consider the inspection plan described in the case study. Do you believe that the supervisory authority has confidence in the work of Motor Insurer’s internal auditing and external auditing? Why or why not?
D. References


Appendix I. ICP 13

ICP 13 Onsite inspection
The supervisory authority carries out onsite inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

Explanatory notes

13.1. Whether performed by the staff of the supervisory authority or other suitably qualified specialists, onsite inspection is an important part of the supervisory process, closely related to the off-site monitoring process. It provides information that supplements the analysis of the reporting to supervisory authorities sent by the insurer. Onsite inspection, however, also needs the support of market information and statistics derived from the analysis of the annual accounts and returns.

13.2. Through onsite inspections the supervisory authority is able to verify or capture reliable data and information to assess and analyze an insurer’s current and prospective solvency. Onsite inspection enables the supervisor to obtain information and detect problems that cannot be easily obtained or detected through ongoing monitoring. In particular, onsite inspections allow the supervisor to identify problems or irregularities in a range of areas, including asset quality, accounting and actuarial practices, internal controls (including those dealing with information technology and outsourcing), quality of underwriting (both the prudence of the underwriting policy and the effectiveness of its implementation in practice), valuation of technical provisions, strategic and operational direction, reinsurance, and risk management.

13.3. Onsite inspections enhance the supervisor’s ability to assess the competence of the managers of insurers. It is also an effective way for supervisors to assess the management’s decision-making processes and internal controls. It provides supervisors the opportunity to analyze the impact of specific regulations and, more generally, to gather information for benchmarking.

13.4. The criteria envisage that onsite inspection may be carried out in a manner that is either “full scale” or “on a focused basis.” Both forms of inspection need to be conducted by skilled staff who can evaluate and analyze the information that they obtain during the inspection. Usually the supervisory authority provides guidance on the scope and procedures for onsite inspections. However, staff performing inspections should use their investigative and technical skills when forming views about the information they obtain.
13.5. Onsite inspection can assist in assessing the risks to which a firm is exposed. A full-scale onsite inspection includes, at a minimum, the following activities:

- Evaluation of the management and internal control system
- Analysis of the nature of the insurer’s activities—for example, the type of business written
- Evaluation of the technical conduct of insurance business or an evaluation of the organization and the management of the insurer, the commercial policy, and the reinsurance cover and its security
- Analysis of the relationships with external entities, such as through outsourcing or with respect to other companies in the same group
- Assessment of the insurer’s financial strength, notably the technical provisions
- Evaluation of compliance with corporate governance requirements.

13.6. A full-scale onsite inspection of market conduct issues includes, at a minimum, the following activities:

- Checking the sufficiency and adequacy of the information given to consumers
- Reviewing the timing of payments
- Reviewing the frequency and nature of litigation
- Assessing observance of the market conduct standards and consumer regulations (refer to ICPs 25 and 26).

13.7. Effective inspections may need to include access to outsourced service providers or other parties to ensure that the inspection adequately addresses insurers who transfer functions and information outside the company. Where another authority supervises the outsourced service provider, supervisory actions should be coordinated (refer to ICP 5).

13.8. The frequency of onsite inspections will take account of the risk profile of the insurer as it appears from previous onsite inspections and offsite monitoring; an additional factor may be the relative importance of the insurer in the market.

**Essential criteria**

a. By law, the supervisory authority has wide-ranging powers to conduct onsite inspections and gather information deemed necessary to perform its duties.

b. The supervisory authority, external auditors, or other suitably qualified parties verify information in regulatory returns periodically through onsite inspections. Where parties other than the supervisory authority verify information, then arrangements for communication with the supervisory authority should be established.
c. The supervisory authority may conduct onsite inspections on either a full-scale or a focused basis investigating areas of specific concern.

d. The supervisory authority promptly discusses findings and any need for corrective action with the insurer and obtains appropriate feedback from the insurer.

e. The supervisory authority follows up with the insurer to ensure that any required action has been taken.

f. The supervisory authority can extend onsite inspections to obtain information from intermediaries and companies that have accepted functions outsourced by the supervised insurer.
Appendix II. Answer key

Pretest

1. b

The fundamental reason for conducting an onsite inspection is to assess current and prospective solvency. See Supervisory Standard on Onsite Inspection, (IAIS 1998, p. 5). The other responses are intermediate objectives that may contribute to the assessment.

2. d

Onsite inspections should be conducted periodically, with the scope and frequency of the inspections taking into account the risk profile and financial position of the insurer. See ICP 13, explanatory note 13.8.

3. c

Substantive testing may include reconciling a material amount shown in the financial statements to the underlying accounting records. The other responses are methods of testing controls, but not substantive testing.

4. d

An effective program of onsite inspections may best be planned in broad terms before beginning inspection activities for the year, with detailed plans established each quarter, in order to deal with new priorities that might arise during the year. Changing priorities and the unpredictability of the findings (hence, the length) of onsite inspections, among other things, require that planning be somewhat flexible.

5. d

See ICP 13, explanatory note 13.5. The assessment of an insurer’s financial strength must include evaluation of the adequacy of the technical provisions. However, it would be unusual for a supervisory authority to recalculate all of an insurer’s technical provisions in detail. Other techniques, such as recalculation on a sampling basis, analysis of claims provisions, and discussions of methods and assumptions with the insurer’s actuary, can be used to assess the adequacy of technical provisions.
6. b

Focused inspections can enable the supervisory authority to concentrate on a limited area of specific concern and assess it more effectively than might be the case during a full-scale inspection, where attention is necessarily spread across many areas.

7. b

Where permitted by law and with appropriate contractual requirements regarding confidentiality, the use of outside experts, such as auditors, actuaries, and investment specialists can contribute to the effectiveness of onsite inspections.

8. a

See ICP 13, essential criterion f.

9. a

See the *Supervisory Standard on On-site Inspection* (IAIS 1998, p. 8). An early discussion of the results helps to avoid factual errors in the conclusions, indicates the insurer’s willingness to take action in response to any concerns, and enables the insurer to begin planning corrective actions immediately. However, it often takes time to turn the findings of an inspection into recommendations, and a formal written report provides documentation in support of follow-up activities and, where appropriate, corrective measures or sanctions.

10. e

The appropriate frequency and nature of follow-up will depend on the seriousness of the concern, the time frame during which corrective action is expected to be taken, the diligence shown by management in implementing its plans, and so forth. Each of the other responses may be appropriate, depending on the specific situation.

**Exercises**

1. Regarding the onsite inspections conducted by your supervisory authority, which inspection activities would you describe as compliance assessment in nature? Process assessment? Risk focused?
Consult with your colleagues, as necessary, to identify the various activities that occur during the onsite inspections in your jurisdiction. Categorize them with reference to the descriptions of the three supervisory approaches in this module (or the more extensive descriptions in the module on ICP 4).

2. **Provide an example of an onsite inspection conducted by you (or others within your supervisory authority) that led to the detection and correction of a problem that could not have been detected through offsite analysis.**

Consider the findings of the onsite inspections in which you have participated or, if your onsite experiences are limited, consult with colleagues.

3. **Describe the processes used by your supervisory authority to plan the inspection program, monitor progress against the plan, and revise the plan during the year.**

Consult with your colleagues, as necessary, to determine the processes used by management.

4. **Identify any circumstances in which the legislation in your jurisdiction would require an onsite inspection. Beyond the legal requirements, what factors are used by your supervisory authority to determine how frequently an onsite inspection of an insurer will be performed?**

Consult with colleagues or review the legislation to identify any requirements that inspections be performed with a specific frequency, or in specific situations—for example, prior to formal supervisory intervention with a problem insurer. Consult with colleagues to identify other factors that influence the frequency of onsite inspections, such as the size of an insurer, its supervisory risk rating, the time that has elapsed since the last inspection, and so forth.

5. **Prepare a rough estimate of the resources used last year by your supervisory authority to perform onsite inspections, according to the following categories: (a) staff whose primary responsibilities are onsite inspections (person/years), (b) staff whose primary responsibilities are in other areas (person/years), and (c) external resources (person/years or financial cost).**

If they are available to you, review the financial and staffing reports of the supervisory authority. Otherwise, consult with management or make your own estimate based on your knowledge of the organization.

6. **Provide an example of a focused inspection that was performed recently by your supervisory authority.**
Consider the inspections in which you have participated and, if necessary, consult with colleagues to identify an example.

7. Explain how your supervisory authority uses the work of others, such as external auditors, internal auditors, and actuaries. Provide an example of a situation where such work influenced the scope of an onsite inspection.

Consider how the work of others is used in the offsite analysis, the nature and extent of communication with those who have performed the work, and how it affects the work of the supervisory authority in each of the main activities of a full-scale onsite inspection (as listed in the section on that topic).

8. Outline the main steps followed by your supervisory authority in performing an onsite inspection, from planning to follow-up. Explain the reasons for the differences, if any, from the steps described in section C of the module.

Review onsite inspection procedure manuals or consult with colleagues to identify the main steps in the inspection process and any differences from the steps described in the module. Reasons for any differences will vary but may, for example, reflect the size of the supervisory authority, the extent to which flexibility exists in the assignment of individuals to inspection teams, and the degree of formality that is observed in communication with insurers.

9. Briefly describe the tools used by your supervisory authority to guide its onsite inspections, such as checklists, assessment criteria, and questionnaires. How were these tools developed? Which of them are available to industry or the public?

Review onsite inspection procedure manuals or consult with colleagues to identify the tools that are used. Consult with colleagues or management to determine how these tools were developed. For example, they may have been developed locally, with or without industry consultation, or they may have been adapted from tools developed by foreign supervisory authorities or international organizations. Review your supervisory authority’s website and other publications to identify which of these tools are available to industry or the public.

10. Briefly describe the approach used by your supervisory authority to document the work and results of its onsite inspections.

Review onsite inspection procedure manuals, descriptions of electronic and paper filing systems, and samples of the reports and letters that are prepared for internal use or communication with the insurers or intermediaries.
11. In order to perform the inspection described in the case study, for which of the items will special expertise likely be required? What types of expertise?

The answer to this question will depend partly on the types of expertise that are generally available within the supervisory authority’s inspection staff, rather than being considered “special.” For example, some supervisory authorities typically include actuaries on their inspection teams, while other supervisory authorities may need to retain foreign consultants in order to acquire such expertise for an inspection. The expertise needed to carry out the various inspection activities could include the following:

<table>
<thead>
<tr>
<th>Types of expertise</th>
<th>Inspection items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronic data analysis and sampling</td>
<td>1, 11, 12, 13</td>
</tr>
<tr>
<td>Motor insurance claims practices</td>
<td>2, 3, 4, 5, 7, 10, 12</td>
</tr>
<tr>
<td>Evaluation of controls</td>
<td>6, 8, 9, 10, 11, 13</td>
</tr>
<tr>
<td>Legal</td>
<td>7</td>
</tr>
<tr>
<td>Anti-money laundering and combating the financing of terrorism</td>
<td>8</td>
</tr>
<tr>
<td>Actuarial</td>
<td>13, 14, 15, 16</td>
</tr>
</tbody>
</table>

12. Consider the inspection plan described in the case study. Do you believe that the supervisory authority has confidence in the work of Motor Insurer’s internal auditing and external auditing? Why or why not?

The supervisory authority probably has relatively little confidence in the work performed by Motor Insurer’s internal auditing function and external auditors. This conclusion is based on the extensive use of substantive procedures in the inspection.