

# **INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS**



## **A NEW FRAMEWORK FOR INSURANCE SUPERVISION: TOWARDS A COMMON STRUCTURE AND COMMON STANDARDS FOR THE ASSESSMENT OF INSURER SOLVENCY**

**OCTOBER 2005**

[This document was prepared by the Solvency and Actuarial Issues Subcommittee in consultation with Members and Observers.]

---

## **A New Framework for Insurance Supervision: Towards a Common Structure and Common Standards for the Assessment of Insurer Solvency**

---

### **Contents**

1. Introduction.....	3
2. The Framework for insurance supervision .....	4
3. A common structure and common standards for the assessment of insurer solvency ....	7

### **1. Introduction**

1. The IAIS was established in 1994. Its objectives<sup>1</sup> are to:

- cooperate to ensure improved supervision of the insurance industry on a domestic as well as on an international level in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders
- promote the development of well-regulated insurance markets
- contribute to global financial stability.

2. Since its inception, the IAIS has developed a range of Principles, Standards and Guidance Papers in pursuit of these objectives. The IAIS *Insurance core principles and methodology* (Insurance Core Principles) address a wide range of issues of relevance to insurance and insurance supervision. These papers have undoubtedly contributed to a convergence of both industry and supervisory principles and practices over the last decade.

3. Insurer solvency takes a central position in risk management by insurers and in insurance supervision. To date the IAIS has developed a number of papers addressing aspects of insurer solvency, based on the Insurance Core Principles and the Principles on capital adequacy and solvency<sup>2</sup>. However the IAIS has not yet articulated a globally acceptable and applicable approach to the financial components of insurance supervision, and in particular to the assessment of insurer solvency.

4. The IAIS has a wide membership covering most jurisdictions of the world. Some insurance lines of business are offered on a global basis and some insurance groups serve a global client base. Other insurance products have a more local flavour, reflecting local markets and conditions, and are offered by more locally operating insurers. Even so, insurance products, markets and companies have many characteristics in common, enabling, and indeed calling for a common, globally acceptable and applicable structure for the assessment of insurer solvency. This common structure must be sufficiently flexible to take into account both the local and the global aspects of insurance.

---

<sup>1</sup> See IAIS By-laws (2004)

<sup>2</sup> Available on the IAIS website: [www.iais.org](http://www.iais.org).

5. The purpose of this paper is to outline the IAIS Framework for insurance supervision, and to show where the financial components of insurance supervision (which include the assessment of insurer solvency) fit within this Framework. A significant current focus for the IAIS is the development, as part of the Framework, of a common structure and common standards for the assessment of insurer solvency.

6. A common structure and common standards for the assessment of insurer solvency will address the IAIS's first objective of improving supervision of the insurance industry for the benefit and protection of policyholders by:

- assisting both industry and the insurance supervisory community in the determination and assessment of the risk and solvency position of insurers, reinsurers and financial groups
- serving to enhance the transparency and comparability of insurers worldwide, to the benefit of consumers, the industry, investors and other interested parties
- strengthening insurance market stability
- supporting a level playing field
- offering further opportunities for international cooperation
- reducing opportunities for unwanted regulatory arbitrage
- increasing public confidence in the insurance sector
- enabling a more effective use of resources by industry and the supervisory community.

7. The remainder of this paper presents the structure of the IAIS Framework for insurance supervision.

8. The IAIS also refers to the related paper *Towards a common structure and common standards for the assessment of insurer solvency: Cornerstones for the formulation of regulatory financial requirements* (also approved in October 2005), which provides further direction to the development of a common structure and common standards for the assessment of insurer solvency.

## **2. The Framework for insurance supervision**

9. As indicated above, the envisaged common structure and common standards for the assessment of insurer solvency will not be developed in isolation but will be embedded in, and be part of, an overarching Framework for insurance supervision that is also globally acceptable and applicable. This Framework serves to clarify and enhance the interrelationship between the solvency standards and the other IAIS Principles, Standards and Guidance Papers agreed so far, and also the interdependencies with other ongoing IAIS work. The Framework brings together the substantial amount of work that the IAIS has already undertaken, and provides structure in identifying priority areas for future IAIS work.

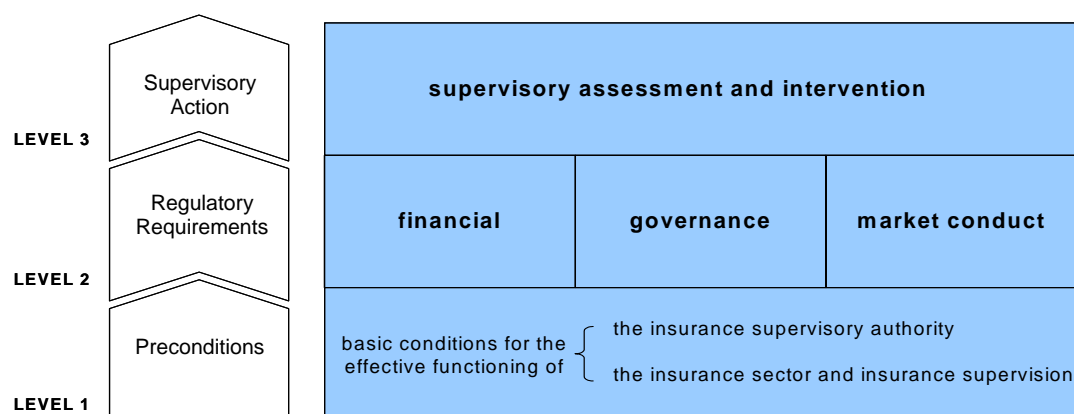
10. In developing a common structure and common standards for the assessment of insurer solvency and formalising an overarching Framework for insurance supervision, the IAIS has taken note, and will continue to take note, of relevant work on insurer solvency undertaken in a number of jurisdictions. The IAIS will also closely follow and carefully consider developments within global fora such as the Bank for International Settlements (BIS), the Basel Committee on Banking Supervision (BCBS), the International Accounting Standards Board (IASB), the International Actuarial Association (IAA), the International Federation of Accountants (IFAC), the International Monetary Fund (IMF), the International Organisation of Securities Commissions (IOSCO), the Organisation for Economic Cooperation and Development (OECD) and the World Bank.

11. A considerable number of large financial groups are active across various financial sectors, and supervisors are now focussing more on specific types of risk, some of which are common to the different financial sectors in which they occur, whereas others are more sector-specific. This means that:

- particular attention needs to be paid to risk-based, supervisory developments in other financial sectors such as 'Basel II'<sup>3</sup>
- the proposed common structure and standards for the assessment of insurer solvency, and the Framework for insurance supervision, need to reflect the particular nature of insurance, and the specific risks associated with it.

12. The wide range of aspects already identified and elaborated to some extent in the Insurance Core Principles suggests that the Framework for insurance supervision consists of three groups of issues: financial issues, governance issues and market conduct issues. It also encapsulates three levels or aspects in relation to these issues, reflecting three different responsibilities: preconditions for effective insurance supervision, regulatory requirements, and supervisory action.

Figure 1: Outline of the Framework for insurance supervision



### Preconditions for effective insurance supervision

13. The Framework for insurance supervision recognises that two sets of basic conditions need to be in place before an effective framework can function.

14. Firstly, effective insurance supervision can only exist within an environment which has:

- a policy, and an institutional and legal framework, for the financial sector and its supervision
- a well developed and effective financial market infrastructure
- efficient financial markets with relevant information available.

In many respects the general, basic conditions for effective insurance supervision are also basic conditions for the effective functioning of an insurance industry in a jurisdiction. Such

<sup>3</sup> *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, Basel Committee on Banking Supervision (June 2004). This is the new capital adequacy framework commonly known as Basel II developed by the Basel Committee on Banking Supervision and approved by the central bank governors and bank supervisory authorities in the Group of Ten (G10) countries in June 2004.

basic conditions are to a large extent outside the direct control or influence of an insurance supervisor or insurer.

15. Secondly, effective insurance supervision can only be implemented if there is a set of clearly defined principal, supervisory objectives, and the existence of a supervisory authority (or authorities) that:

- has adequate powers, legal protection and financial resources to exercise its functions and powers
- is operationally independent, notably from political authorities and from insurers
- is accountable and transparent in the exercise of its functions and powers
- hires, trains and maintains sufficient staff with high professional standards
- treats confidential information appropriately.

This set of basic conditions builds on the more fundamental prerequisites outlined above, and pertains more specifically to the responsibilities, means and functioning of the insurance supervisory authority.

### Regulatory Requirements

16. Supported by these preconditions, the Framework consists of three broadly defined categories or “blocks” of issues, which relate to:

- the financial aspects of an insurer’s operations
- how an insurer is governed
- how an insurer conducts its business and presents itself in the market.

17. Each of these blocks may be viewed from two main standpoints or aspects:

- regulatory requirements, which are addressed to the operations of the insurer
- supervisory action, which has regard to the responsibilities and activities of the supervisory authority.

18. It is the responsibility of insurers to meet regulatory requirements, both qualitative and quantitative, in pursuing their insurance activities. Such requirements may be enshrined in law or regulations, or be imposed by the supervisory authority, but need to be broad enough to deal with the full range of insurers in the market. The three blocks are:

- the financial block – this pertains to the field of solvency and capital adequacy; valuation and adequacy of technical provisions; forms of capital; investments; and financial reporting and disclosure
- the governance block – this refers to governance processes and controls in areas such as the Board, directors, senior management and other organisational aspects, fit and proper testing of directors and management; administrative, organisation and internal controls, including risk management; compliance with legislative requirements; shareholder relationships; and the governance risks posed by group structures
- the market conduct block – this includes areas such as dealing with customers in the selling and handling of insurance policies, and also the integrity of conduct by an insurer as an institutional investor. It also includes disclosure of relevant information both to the market and to policyholders.

### Supervisory Action

19. Adherence by insurers to all such requirements needs to be subject to supervisory review. Assessment of an insurer's risk profile, controls and available support are also integral to supervisory reviews. Supervisors must assess individual insurers, taking into account the specific circumstances of each insurer. More specifically, the supervisor will need to tailor its review, and any remedial action taken, to the risk profile and specificities of each insurer, with due regard to the principles of legal certainty and equal treatment. The supervisory action 'level' in the Framework thus illustrates the field of responsibility of the supervisory authority, and its responsibility to take appropriate action when this is called for.

### Framework Solidity

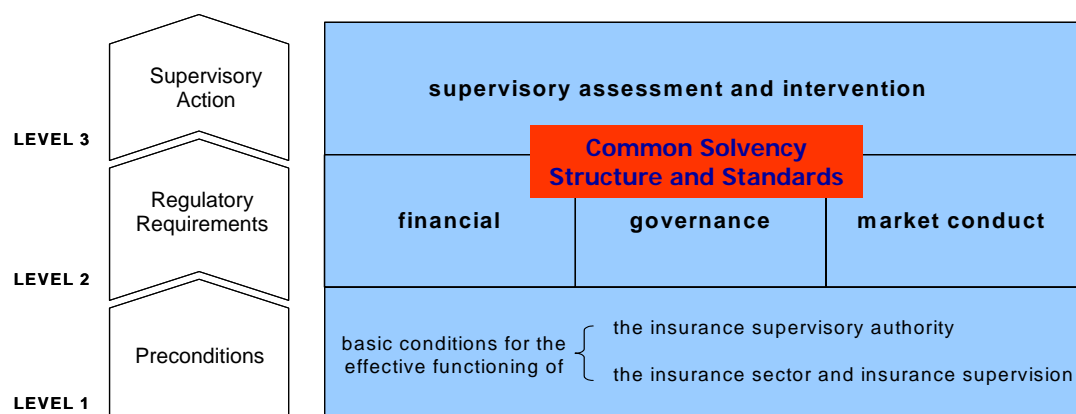
20. The contents of each of the elements of the Framework are interdependent; to keep the Framework stable and effective, less stringent requirements in one element imply a need for stronger measures in the others. However, a minimum level of coverage of each Framework element needs to be determined at a sufficiently exacting and granular level and agreed upon as an internationally acceptable standard. This combination of minimum coverage with compensating interdependence provides a solid overall framework.

21. The Framework for insurance supervision encompasses the overall spectrum of insurance and insurance supervision. It is also compatible with the approach of 'Basel II'. Both address regulatory requirements, supervisory review and market discipline through disclosure, although they are structured differently. For example, in the Framework for insurance supervision, all regulatory requirements, including those addressing public disclosure, appear at the same 'level'. Such disclosure requirements may pertain to each of the three blocks: financial, governance or market conduct. Adherence to these disclosure requirements would form part of the supervisory assessment. However, the effectiveness of public disclosure would be seen as the responsibility of the market, under the presumption that insurers meet their disclosure requirements. The Framework is based on the view that insurance supervision has a role in assessing whether insurers meet their disclosure requirements both to the market and to policyholders, but that it cannot ensure that market forces play their envisaged beneficial preventative and corrective role.

## **3. A common structure and common standards for the assessment of insurer solvency**

22. The common structure and standards for the assessment of insurer solvency that are to be developed are an important part of the 'financial block' in the Framework. However they will also address components of the governance and market conduct blocks. The structure and standards will firstly address level 2 (regulatory requirements) and then be expanded into level 3 (supervisory actions). As illustrated, the effectiveness of such solvency standards will be dependent upon the other elements of the Framework. The position of the common structure and standards within the Framework is illustrated as follows.

Figure 2: The common solvency structure and standards within the Framework for insurance supervision



23. The IAIS formulates in the 'Cornerstones paper' mentioned above a more precise view on a number of key elements or 'cornerstones' in the common structure and common standards for the assessment of insurer solvency.

24. The cornerstones, in turn, will be elaborated upon in further work. A roadmap paper outlining further steps in this project is currently under development. The IAIS envisages circulating the roadmap paper for comments and suggestions later this year.