INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

INSURANCE PRINCIPLES, STANDARDS AND GUIDANCE PAPERS

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Foreword

About the International Association of Insurance Supervisors (IAIS)

The IAIS was established in 1994. Its membership includes insurance regulators and supervisors of some 180 jurisdictions in more than 120 countries. Its objectives 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.

The IAIS develops principles and standards on insurance supervision. In doing so, it helps establish and maintain fair and efficient insurance markets for the benefit and protection of policyholders. The IAIS also prepares issues papers that provide background on specific areas of interest to insurance supervisors.

The IAIS is active in promoting the implementation of its supervisory standards through training activities. It works closely with international organisations, regional groups and supervisory authorities to accomplish this mission. The IAIS also develops implementation tools such as case studies on supervisory issues.

The IAIS contributes to assessments of jurisdictions' observance of standards in close collaboration with the IMF and World Bank. The Insurance Core Principles, methodology and self-assessment questionnaire are used for this purpose and by any jurisdiction wishing to improve its supervisory laws and practices. In this regard the IAIS maintains a list of qualified insurance experts able to conduct assessments.

The IAIS collaborates closely with other international regulatory organisations. In particular, the IAIS is one of the constituting bodies of the Joint Forum and participates in all of its working groups. It is represented on the Financial Stability Forum. The IAIS provides input to the International Accounting Standards Board's work in establishing standards for insurance accounting and has two representatives on their Insurance Working Group, and one on their Standards Advisory Council. It also has observer status on the Financial Action Task Force.

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Insurance Principles, Standards and

Guidance Papers

The IAIS is committed to developing standards that can be used by insurance supervision throughout the world. IAIS papers represent best practices, or targets, for supervisors to work towards; they can be implemented in a flexible manner depending on the circumstances within each jurisdiction.

Please use the links below to access the papers listed.

Principles

The IAIS sets out principles that are fundamental to effective insurance supervision. The principles identify areas in which the insurance supervisor should have authority or control. These form the basis from which standards are developed.

Periodically, members carry out self-assessments to determine whether the principles of insurance supervision are being substantially complied to within their jurisdictions.

1. Insurance core principles and methodology
   October 2003
2. Supervision of international insurers and insurance groups and their cross-border business operations
   December 1999
3. Conduct of insurance business
   December 1999
4. Supervision of insurance activities on the Internet
   October 2004
5. Capital adequacy and solvency
   January 2002
6. Minimum requirements for supervision of reinsurers
   October 2002

Standards

Standards focus on particular issues and describe best or most prudent practices. In some cases, standards will set out best practices for a supervisory authority; in others, the papers describe the practices a well managed insurance company would be expected to follow and, thereby, assist supervisors in assessing the practices that companies in their jurisdictions have in place.

1. Licensing
   October 1998
2. On-site inspections
   October 1998
3. Derivatives
   October 1998
4. Asset management by insurance companies
   December 1999
5. Group coordination
   October 2000
6. Exchange of information
   January 2002
7. Evaluation of the reinsurance cover
   January 2002

8. Supervision of reinsurers
   October 2003
9. Disclosures concerning technical performance and risks for non-life insurers and reinsurers
   October 2004

Guidance papers

Guidance papers are an adjunct to principles and standards. They are designed to assist supervisors, although sometimes they are addressed to insurance companies.

1. Insurance regulation and supervision for emerging market economies
   September 1997
2. A Model memorandum of understanding (to facilitate the exchange of information between financial supervisors)
   September 1997
3. Fit and proper principles and their application
   October 2000
4. Public disclosure by insurers
   January 2002
5. Anti-money laundering and combating the financing of terrorism
   October 2004
6. Solvency control levels
   October 2003
7. The Use of actuaries as part of a supervisory model guidance paper
   October 2003
8. Stress testing by insurers
   October 2003
9. Investment risk management
   October 2004

Principles No. 1

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

INSURANCE CORE PRINCIPLES AND METHODOLOGY

October 2003

[This document was prepared by the Task Force on the Revisions to the Insurance Core Principles in consultation with members and observers.]

Insurance core principles and methodology

The *Insurance core principles and methodology* consist of

- essential principles that need to be in place for a supervisory system to be effective
- explanatory notes that set out the rationale underlying each principle
- criteria to facilitate comprehensive and consistent assessments.

This document should serve as a basic benchmark for insurance supervisors in all jurisdictions. It can be used when establishing a supervisory regime or for identifying areas in existing regimes that need to be improved.

Public authorities concerned with issues of financial stability are urged to provide the necessary support to the supervisory authority so that it can meet the principles and the criteria set out herein.

Contents

1. Introduction

1. To contribute to economic growth, efficiently allocate resources, manage risk, and mobilise long-term savings, the insurance sector must operate on a financially sound basis. A well-developed insurance sector also helps enhance overall efficiency of the financial system by reducing transaction costs, creating liquidity, and facilitating economies of scale in investment. A sound regulatory and supervisory system is necessary for maintaining efficient, safe, fair and stable insurance markets and for promoting growth and competition in the sector. Such markets benefit and protect policyholders[1]. Sound macroeconomic policies are also essential for the effective performance of insurance supervisory regimes.

2. The insurance industry, like other components of the financial system, is changing in response to a wide range of social and economic forces. In particular, insurance and insurance-linked financial activities are increasingly crossing national and sectoral boundaries. Technological advances are facilitating innovation. Insurance supervisory systems and practices must be continually upgraded to cope with these developments. Furthermore insurance and other financial sector supervisors and regulators should understand and address financial and systemic stability concerns arising from the insurance sector as they emerge.

3. The nature of insurance activity - covering risks for the economy, financial and corporate undertakings and households - has both differences and similarities when compared to the other financial sectors. Insurance, unlike most financial products, is characterised by the reversal of the production cycle insofar as premiums are collected when the contract is entered into and claims and costs arise only if a specified event occurs. Insurers intermediate risks directly. They manage these risks through diversification and the law of large numbers enhanced by a range of other techniques.

4. Aside from the direct business risks, significant risks to insurers are generated on the liability side of the balance sheet. These risks are referred to as technical risks and relate to the actuarial or statistical calculations used in estimating liabilities. On the asset side of the balance sheet, insurers incur market, credit, and liquidity risk from their investments and financial operations, as well as risks arising from asset-liability mismatches. Life insurers also offer products of life cover with a savings content and pension products that are usually managed with a long-term perspective. The supervisory framework must address all these aspects.

5. Finally, the supervisory framework needs to reflect the increasing presence in the market of financial conglomerates and groups, as well as financial convergence. The importance of the insurance sector for financial stability has been increasing. This trend has implications for insurance supervision as it requires more focus on a broader set of risks. Supervisory authorities at a national and international level must collaborate to ensure that these entities are effectively supervised so that business and individual policyholders are protected and financial markets remain stable; to avoid

[1] In this document policyholder includes beneficiaries.

contagious risks being transferred from one sector or jurisdiction to another; and to avoid supervisory duplication.

Scope and coverage of the *Insurance core principles*

6. The *Insurance core principles* provide a globally-accepted framework for the regulation and supervision of the insurance sector. IAIS principles, standards and guidance papers expand on various aspects. They provide the basis for evaluating insurance legislation, and supervisory systems and procedures.

7. The principles apply to the supervision of insurers and reinsurers, whether private or government-controlled insurers that compete with private enterprises, wherever their business is conducted, including through e-commerce. The term insurer refers to both insurers and reinsurers. Where the principles do not apply to reinsurers (such as, consumer protection), this is indicated in the text. Conversely, the core principles do not normally apply to the supervision of intermediaries, however, where they do this is specifically indicated.

8. Insurance supervision within an individual jurisdiction may be the responsibility of more than one authority. For example, the body that sets out the legal framework for insurance supervision may be different from the body that implements it. In this document, the expectation is that the core principles are applied within the jurisdiction rather than necessarily by one supervisory authority. It is, however, essential that in situations where multiple authorities exist, coordination arrangements be established to ensure the implementation of the core principles within an accountable framework.

9. The supervisory authority must operate in a transparent and accountable manner. It needs legal authority to perform its tasks. It should be noted, however, that the possession of authority is not enough to demonstrate observance with a principle. The supervisory authority should exercise its authority in practice. Similarly it is not enough for the supervisory authority to set requirements; it should also ensure that these requirements are implemented. Having the necessary resources and capacity is essential for the supervisory authority to effectively implement the requirements.

10. The supervisor must recognise that transparency and accountability in all its functions contribute to its legitimacy and credibility, and the efficiency and stability of the market. A critical element of transparency is for supervisors to provide the opportunity for meaningful public consultation on the development of supervisory policies, and in the establishment of new and amended rules and regulations. To further ensure the proper and efficient operation of the market, supervisors should establish clear timelines for public consultation and action, where appropriate.

Implementation and assessment

11. The *Insurance core principles* can be used to establish or enhance a jurisdiction's supervisory framework. They can also serve as the basis for assessing the existing supervisory framework and in so doing may identify weaknesses, some of which could affect policyholder protection and market stability. In order to ensure that the core principles are interpreted and implemented in a consistent manner by insurance supervisory authorities, each principle is followed by an explanatory note and criteria. Annex 1 contains a list of IAIS principles, standards and guidance documents, as well as selected codes, that expand on some of the core principles. This list will be updated as new principles, standards and guidance are developed. Annex 2 sets out factors that should be considered when using or implementing these principles and describes how observance should be evaluated.

12. The criteria, which must be implemented both in form and in practice, consist of two distinct groupings:
(i) essential criteria, or those components that are intrinsic to the implementation of the core principle. All the essential elements should be met for a supervisory authority to demonstrate "observed" status for each principle.
(ii) advanced criteria, or those components that are considered to improve on the essential criteria and thus enhance the supervisory regime. Advanced criteria are not used for assessing observance with a principle, rather they are used when commenting on a jurisdiction's supervisory framework and making recommendations[2].

13. While implementing the criteria in a jurisdiction, and when carrying out the assessment, it is important to take into account the domestic context, industry, structure and stage of development of the financial system and overall macroeconomic conditions. The ways and means of implementation will vary across jurisdictions, and while good implementation practices should be kept in mind, there is no mandated method of implementation. For example, in some jurisdictions the supervisory authority may, within clear limits and following a consultative process, be able to issue guidelines or establish regulations that insurers must follow, whereas in other jurisdictions these powers may reside with the legislature.[3]

14. For a core principle to be regarded as being "observed" the essential criteria must be met without any significant shortcomings although there may be instances, where one can demonstrate that the principles have been observed through different means other than those identified in the criteria. Conversely, owing to the specific conditions in individual jurisdictions, the criteria identified in this document may not always be sufficient to achieve the objective of the specific principle and therefore additional elements may have to be taken into account.

2. Conditions for effective insurance supervision

ICP 1	**Conditions for effective insurance supervision**
	Insurance supervision relies upon • a policy, institutional and legal framework for financial sector supervision • a well developed and effective financial market infrastructure • efficient financial markets.

Explanatory note

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

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

[2] Recommendations may also arise from comments made about the observation of the essential criteria.

[3] In this document, "law" requires full legislative consent; "legislation" refers to either laws or other forms of regulatory rules (e.g., regulations, decrees, ordinance).

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

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

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

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

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

Financial sector policy framework

Essential criteria

a. The government establishes and publicly discloses a policy statement aimed at ensuring financial stability, including the provision of effective financial sector supervision covering the insurance and other financial sectors.

b. An institutional and legal framework – comprising public institutions, laws and regulations – exists for financial sector issues, including those pertaining to insurance, to address system-wide issues. This framework is well-defined and publicly disclosed.

Financial market infrastructure

Essential criteria

c. There is a reliable, effective, efficient and fair legal and court system (a body of ethical, professional and trained lawyers and judges) whose decisions are enforceable. Alternative dispute mechanisms operate within an appropriate legal framework.

d. Accounting, actuarial and auditing standards are comprehensive, documented, transparent and consistent with international standards. Accounting and actuarial standards are applied and disclosed in a manner that allows current and prospective policyholders, investors, intermediaries, creditors and supervisors to properly evaluate the financial condition of insurers.

e. Accountants, actuaries and auditors are competent and experienced and comply with technical and ethical standards to ensure the accuracy and reliability of financial data and its interpretation. Auditors are independent from the insurer.

f. Professional bodies set and enforce technical and ethical standards. These standards are accessible to the public.

g. Basic economic, financial and social statistics are available to the supervisory authority, the industry and the public.

Advanced criteria

h. Laws and regulations are updated, as necessary, to reflect current best practices and industry conditions.

Efficient financial markets

Essential criteria

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

3. The supervisory system

ICP 2	**Supervisory objectives**
	The principal objectives of insurance supervision are clearly defined.

Explanatory note

2.1. The insurance law should include a clear statement of the mandate and responsibilities of the supervisory authority. This gives prominence to the authority's role. Publicly defined objectives also foster transparency. With this basis the public, government, legislatures and other interested bodies can form expectations about insurance supervision and assess how well the authority is achieving its mandate and fulfilling its responsibilities legislation.

2.2. Being entrenched in law also ensures that the mandate and functions of the supervisory authority cannot be changed on an *ad hoc* basis. The process of periodically altering the governing laws can promote transparency by way of public discussions on relevant issues; however, if done too frequently stakeholders may form the impression that the policymaking process is unstable. Therefore it would be prudent to avoid being overly specific. Instead the law could be supplemented as needed with updated regulations, for example.

2.3. The law should also set forth the institutional framework or the basic conceptual structure governing the institutions involved in the design and implementation of insurance supervisory policies, identifying, wherever appropriate, the broader set of relevant financial agencies and the nature of the relationships among them.

2.4. Often the supervisory authority's mandate includes several objectives. As financial markets evolve and depending on current financial conditions, the emphasis a supervisory authority places on a particular objective may change and, where requested, this should be explained.

Essential criteria

a. Legislation or regulation clearly defines the objectives of insurance supervision .

b. The key objectives of supervision promote the maintenance of efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders.

c. In the event that the law mandates or specifies multiple objectives for insurance supervision, the supervisory authority discloses and explains how each objective will be applied.

d. The supervisory authority gives reasons for and explains any deviations from its objectives.

e. Where objectives are contradictory, the supervisory authority initiates or proposes correction in law or regulation.

ICP 3 Supervisory authority

The supervisory authority:

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

Explanatory note

3.1. The supervisory authority must be fully empowered to achieve its objectives. The principle therefore covers the following essential elements relating to a supervisory authority: its legal basis, independence and accountability, powers, financial resources, human resources, legal protection and confidentiality.

3.2. Independence, accountability, transparency and integrity interact and reinforce each other. Transparency is a vehicle for safeguarding independence, ensuring accountability, and establishing and safeguarding integrity.

3.3. To support the independence and integrity of the supervisors, there should be provisions for the legal protection of staff, as well as clear rules for appointment and removal of the head of the supervisory authority. These should be publicly disclosed. The supervisory authority should be operationally independent from external political and commercial interference in the exercise of its functions and powers. Independence enhances the credibility and effectiveness of the supervisory process. The existence of an appeals mechanism through the courts helps ensure that regulatory and supervisory decisions are made within the law consistently and are well reasoned.

3.4. It is important to define the relationship between the supervisory authority and the executive and judicial branches, including processes for sharing information, consultation or approval with the relevant ministry and the manner in which the supervisory authority could be subject to judicial

review. This might include establishing what information should be provided, how each entity should consult on matters of mutual interest and when approval from relevant ministries is necessary.

Legal framework

Essential criteria

a. The legislation identifies the authority (or authorities) responsible for the supervision of insurance entities.

b. The legislation gives the supervisory authorities the power to issue and enforce rules by administrative means (refer to ICP 4 EC a).

c. The legislation grants sufficient powers for the effective discharge of supervisory responsibilities.

Independence and accountability

Essential criteria

d. The governance structure of the supervisory authority is clearly defined. Internal governance procedures necessary to ensure the integrity of supervisory operations, including internal audit arrangements, are in place.

e. There are explicit procedures regarding the appointment and dismissal of the head and members of the governing body. When the head of an authority or the governing body is removed from office, the reasons are publicly disclosed.

f. The institutional relationships between the supervisory authority and executive and the judiciary branches are clearly defined and transparent. Circumstances where executive overrides are allowed are specified.

g. The supervisory authority and its staff are free from undue political, governmental and industry interference in the performance of supervisory responsibilities.

h. The supervisory authority is financed in a manner that does not undermine its independence from political, governmental or industry bodies.

i. The supervisory authority has discretion to allocate its resources in accordance with its mandate and objectives and the risks it perceives.

j. The supervisory authority has transparent processes and procedures for making supervisory decisions. Supervisory decisions are demonstrably consistent.

k. All material changes to the insurance legislation and supervisory practices are normally subject to prior consultations with market participants.

Advanced criteria

l. Representatives of the supervisory authority publicly explain their policy objectives, and report on their activities and performance in pursuing their objectives.

m. Subject to confidentiality considerations, information is provided publicly about problem or failed insurers, including information on official actions taken.

Powers

Essential criteria

n. When necessary, the supervisory authority has the power to take immediate action to achieve its objectives, especially to protect policyholders' interests (refer to ICP 4 EC e).

Financial resources

Essential criteria

o. The supervisory authority has its own budget sufficient to enable it to conduct effective supervision. The supervisory authority is able to attract and retain highly skilled staff, hire outside experts as necessary, provide training, and rely upon an adequate supervisory infrastructure and tools.

p. The supervisory authority publishes audited financial statements on a regular basis.

Human resources and legal protection

Essential criteria

q. The supervisory authority and its staff

- observe the highest professional standards
- have the appropriate levels of skills and experience have the necessary legal protection to protect them against lawsuits for actions taken in good faith while discharging their duties, provided they have not acted illegally
- are adequately protected against the costs of defending their actions while discharging their duties
- act with integrity. Supervisory staff are subject to conflict of interest rules, such as prohibition on dealing in shares and investing in the companies they supervise. The supervisory authority establishes and enforces a code of conduct that applies to all staff members.

r. The supervisory authority has the authority to hire, contract or retain the services of external specialists through contracts or outsourcing arrangements if necessary.

s. Where supervisory functions are outsourced to third parties, the supervisory authority is able to assess their competence, monitor their performance, and ensure their independence from the insurer or any other related party.

Confidentiality

Essential criteria

t. The supervisory authority maintains appropriate safeguards for the protection of confidential information in its possession. Other than when required by law, or when requested by another supervisor who has a legitimate supervisory interest and the ability to uphold the confidentiality of the requested information, the supervisory authority denies requests for confidential information in its possession (refer to ICP 5).

u. External specialists hired by the supervisory authority are subject to the same confidentiality and code of conduct requirements as the staff of the supervisory authority.

ICP 4 Supervisory process

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

Explanatory note

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

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

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

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

Essential criteria

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

b. The supervisory authority applies all regulations and administrative procedures consistently and equitably, taking into account the different risk profiles of insurers.

c. The administrative decisions of the supervisory authority can be subject to substantive judicial review. However, such action must not unduly impede the ability of the supervisory authority to make timely interventions in order to protect policyholders' interests.

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

e. The decision-making lines of the supervisory authority are so structured that action can be taken immediately in the case of an emergency situation (refer to ICP 3 EC n and ICP 15).

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

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

Advanced criteria

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

ICP 5 Supervisory cooperation and information sharing

The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.

Explanatory note

5.1. Efficient and timely exchange of information among supervisory bodies, both within the insurance sector and across the financial services sector, is critical to the effective supervision particularly in the case of internationally active insurers, insurance groups and financial conglomerates. This is also essential in the context of the effective supervision of the financial system as a whole.

5.2. Information sharing arrangements should facilitate prompt and appropriate action in situations where material supervisory issues need to be addressed. Increasingly supervisors need to share information on matters relating to fraud, anti-money laundering and the combating of financing of terrorism.

5.3. The supervisory authority maintains the confidentiality of the supervisory information it receives from another supervisor. Without adequate safeguards on confidentiality, supervisors will find that their access to confidential information is denied or delayed and their ability to carry out supervisory responsibilities severely diminished.

Essential criteria

a. The existence of a formal agreement with another supervisor is not a prerequisite for information sharing.

b. The supervisory authority, at its discretion, can enter into agreements or understandings with any other financial sector supervisor ("another supervisor") to share relevant supervisory information or to otherwise work together.

c. When reasonably requested and with appropriate safeguards, the supervisory authority is able to exchange with another supervisor (refer to ICP 7 EC e) the following:
   - relevant supervisory information, including specific information requested and gathered from a supervised entity
   - relevant financial data
   - objective information on individuals holding positions of responsibility in such entities.

d. Information sharing, whether carried out under formal or informal arrangements, allows for a two-way flow of information without requiring strict reciprocity in terms of the level, format and detailed characteristics of the information exchanged.

e. The home supervisory authority provides relevant information to the host supervisor.

f. The supervisory authority is required to take reasonable steps to ensure that any information released to another supervisor will be treated as confidential by the receiving supervisor and will be used only for supervisory purposes.

g. The supervisory authority consults with another supervisor if it proposes to take action on the evidence of the information received from that supervisor.

h. The home supervisory authority informs relevant host supervisors of any material changes in supervision that may have a significant bearing on the operations of foreign establishments operating in their jurisdictions.

i. Where possible, the home supervisory authority informs the host supervisor in advance of taking any action that will affect the foreign establishment in the host supervisor's jurisdiction.

j. Where possible, the host supervisory authority informs the home supervisor in advance of taking any action that will affect the parent company or headquarters in the home supervisor's jurisdiction.

4. The supervised entity

ICP 6	**Licensing**
	An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.

Explanatory note

6.1. To protect the interest of policyholders a jurisdiction must be able to determine which insurers are allowed to carry out insurance activities within its area. Licensing refers to the formal authority given to an insurer to carry on insurance business under the domestic insurance legislation. It does not refer to any approval granted in terms of the general domestic company or business legislation.

6.2. When the licensing procedure meets internationally accepted standards and is effective and impartial, confidence in the supervisory system will grow and may facilitate mutual recognition of supervisory systems and thus the further liberalisation of market access for foreign insurers. Licensing procedures and conditions are in place for supervisory purposes; they should not in themselves act as a barrier to market access.

Essential criteria

a. The insurance legislation:
- includes a definition of insurers
- requires licensing of insurers, and prohibits unauthorised insurance activities
- defines the permissible legal forms of insurers
- allocates the responsibility for issuing licences.

b. Clear, objective and public licensing criteria require:
- the applicant's board members, senior management, auditor and actuary both individually and collectively to be suitable, as specified in ICP 7
- the applicant's significant owners (refer to ICP 8 EC a) to be suitable, as specified in ICP 7
- the applicant to hold the required capital
- the applicant's risk management systems including reinsurance arrangements, internal control systems, information technology systems, policies and procedures to be adequate for the nature and scale of the business in question
- information on the applicant's business plan projected out for a minimum of three years. The business plan must reflect the business lines and risk profile, and give details of projected setting-up costs, capital requirements, projected development of business, solvency margins and reinsurance arrangements. The business plan must present information regarding primary insurance and inward reinsurance separately
- information on the products to be offered by the insurer
- information on contracts with affiliates and outsourcing arrangements
- information on the applicant's reporting arrangements, both internally to its own management and externally to the supervisory authority
- input from the applicant's home supervisory authority when the insurer or its owners are not domestic and a home supervisory authority exists (refer to ICP 5).

c. The supervisory authority requires that no domestic or foreign insurance establishment escape supervision.

d. All insurance establishments of international insurance groups and international insurers are subject to effective supervision. The creation of a cross border establishment should be subject to consultation between the host and home supervisor.

e. The insurance legislation determines the method by which a foreign insurer can carry on business in the jurisdiction. This may be by way of a local branch or subsidiary that must be licensed, or on a services basis only.

f. If a foreign insurer is allowed to carry on business in the jurisdiction the supervisory authority must be provided with the following data:
- confirmation from the home supervisory authority that the insurer is authorised to carry on the types of insurance business proposed
- information from the home supervisory authority that the insurer is solvent and meets all the regulatory requirements in the home jurisdiction
- in the case of a branch office: the name and address of the branch
- the name of the authorised agent in the local jurisdiction in the case of insurance offered on a services basis (i.e., where a local branch or subsidiary is not established)
- the information and documentation normally required to be licensed in the local jurisdiction, when appropriate

These information requirements might be waived if insurance is offered on a services basis only.

g. An insurer licensed to underwrite life insurance business must not also be licensed to underwrite non-life insurance business, and vice versa, unless the supervisory authority is satisfied that the insurer has satisfactory processes requiring that risks be handled separately on both a going-concern and a winding-up basis.

h. The supervisory authority imposes additional requirements, conditions or restrictions on an applicant where the supervisory authority considers this appropriate. This might include restrictions on non-insurance activities.

i. The supervisory authority assesses the application and makes a decision within a reasonable time. No licence is issued without its approval. The applicant must be informed of the decision without delay and, if the licence is denied or conditional, be provided with an explanation.

j. The supervisory authority refuses to issue a licence where it considers the applicant not to have sufficient resources to maintain the insurer's solvency on an on-going basis, where the organisational (or group) structure hinders effective supervision, or where the application is not in accordance with the licensing criteria.

k. As necessary, after an insurer has been licensed, the supervisory authority evaluates and monitors the degree to which the insurer satisfies the relevant licensing principles and requirements of the jurisdiction.

ICP 7 Suitability of persons

The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

Explanatory note

7.1. An important element of the supervision of insurers is the initial and on-going assessment of the fitness and propriety of an insurer's significant owners and key functionaries such as board members, senior management, auditors and actuaries. In the case of significant owners, fit and proper requirements relate to the persons and their financial soundness. A significant owner is defined as a person (legal or natural) that directly or indirectly, alone or with an associate, exercises control over the insurer (refer to ICP 8 EC a). The main responsibility for assessment of the fitness and propriety of key functionaries lies with the insurers themselves.

7.2. The supervisory authority should be satisfied that significant owners and key functionaries have the level of competence for their roles, and should ascertain whether they have the appropriate ability and integrity to conduct insurance business, taking account of potential conflicts of interests. Appropriate ability can generally be judged from the level of a person's professional or formal qualifications or relevant experience within the insurance and financial industries or other related businesses.

Essential criteria

a. Legislation identifies which key functionaries must meet fit and proper requirements. The key functionaries identified may differ depending on the legal form and governance structure of the insurer.

b. In cases where significant owners no longer meet fit and proper requirements, the supervisory authority must be able to take appropriate action, including requiring that the owners dispose of their interests.

c. The supervisory authority disqualifies the appointment of key functionaries including auditors and actuaries of insurers that do not comply with fit and proper requirements

d. The insurer should be required to demonstrate to the supervisory authority the fitness and propriety of key functionaries by submitting documentation illustrating their knowledge, experience, skills and integrity upon request, or where there are changes in key functionaries. The knowledge and experience required depends on the position and responsibility of the functionary within the insurer.

e. The supervisory authority exchanges information with other authorities inside and outside its jurisdiction where necessary to check the suitability of persons. The supervisory authority uses this information as an additional tool to effectively assess the fitness and propriety of, or to obtain information on, a key functionary of an insurer (refer to ICP 5).

f. The supervisory authority disallows actuaries, auditors, directors and senior managers, from simultaneously holding two positions in an insurer where this could result in a material conflict.

g. Where the insurer becomes aware of circumstances that may be relevant to the fitness and propriety of its key functionaries, it is required to notify the supervisory authority as soon as possible.

Advanced criteria

h. Criteria to assess the fitness and propriety of auditors' and actuaries' include qualifications, professional proficiency, appropriate practical experience and updated knowledge on developments within their profession and membership of professional bodies.

i. In the case of auditors and actuaries, the supervisory authority may give regard to or rely on professional bodies that set and enforce standards of professional conduct.

ICP 8	**Changes in control and portfolio transfers**
	The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer. The supervisory authority approves the portfolio transfer or merger of insurance business.

Explanatory note

8.1. The supervisory authority must be able to grant or deny approval to a person (legal or natural) that wants to acquire significant ownership or a controlling interest in an insurer, whether directly or indirectly, alone or with an associate. The concepts of significant ownership or control should be defined in legislation.

8.2. Notification should be required for changes in ownership or control according to the percentages of an insurer's issued shares. These established percentages typically range between 5 and 10 percent. Where supervisory approval is required in addition to notification, specific thresholds (equal to or higher than those for notification) should be set.

8.3. The supervisory authority must require that the proposed owners have the resources to provide the minimum capital required as well as the ability to provide further capital or other support for the insurer when needed.

8.4. Owners should not expose the insurer to undue risks or hinder effective supervision. The supervisory authority should be satisfied about what constitutes an insurance group or conglomerate and which entities are considered to be part of such a group. The structure and risk profile of the group to which the insurer belongs should not damage the insurer's stability and solvency (refer to ICP 17).

8.5. Changes in control have an indirect effect on the contractual arrangements between insurer and policyholder, whereas a portfolio transfer will have a direct effect on this relationship. For this reason supervisory authorities should closely monitor portfolio transfers.

8.6. Insurance policies are legal contracts between an insurer and its policyholders. An insurer should not be able to unilaterally alter the terms of a contract by merging with another insurer, mutualising or demutualising or transferring some of its policy liabilities to another insurer. In order to protect the interests of policyholders, legislation should restrict the ability of insurers to transfer their policy liabilities. The supervisory authority must ensure that policyholders' reasonable benefit expectations and existing policy values will not normally be lessened as a result of liability transfer. This should apply whether the transfer involves a single policy or a portfolio or the transaction is considered a part of normal business, a merger or part of a winding-up procedure in a situation where the insurer is no longer financially viable or is insolvent (refer to ICP 16).

Changes in control

Essential criteria

a. The term "control" over an insurer is defined in legislation and it addresses:
   - holding of a defined number or percentage of issued shares or specified financial instruments (such as compulsory convertible debentures) above a designated threshold in an insurer or its intermediate or ultimate beneficial owner
   - voting rights attached to the aforementioned shares or financial instruments
   - power to appoint or remove directors to the board and other executive committees.

b. The supervisory authority requires that the potential controlling owners apply for approval for the acquisition, or change in control, of the insurers. The insurer must inform the supervisory authority of any acquisitions or changes in control.

c. The supervisory authority approves any significant increase in shareholdings above the predetermined control levels in an insurer by legal or natural persons, whether obtained individually or in association with others. This also applies to any other interest in that insurer or its intermediate or ultimate beneficial owners.

d. The requirements in criteria b and c above also refer to the acquisition or change of control where the intermediate or ultimate beneficial owner(s) of an insurer is (are) outside the jurisdiction where the insurer is incorporated. Supervision of changes in control may require coordination with supervisors in other jurisdictions (refer to ICP 5).

e. The supervisory authority must be satisfied that those seeking control meet the criteria applied during the licensing process. The requirements in ICP 7 – Suitability of persons – will apply to the prospective owners in control of insurers.

f. The supervisory authority requires that the structures of the financial groups containing potential controlling owners of insurers be sufficiently transparent so that supervision of the insurance group will not be hindered (refer to ICP 17).

g. The supervisory authority rejects applications of proposed owners to control insurers if facts exist from which it can be deduced that their ownership will be unduly prejudicial to policyholders. The supervisory authority should know who is the intended beneficial owner.

h. To assess applications for proposed acquisitions or changes in control of insurers the supervisory authority establishes requirements for financial and non-financial resources.

Advanced criteria

i. Upon request insurers provide the supervisory authority with information on their shareholders and any other person directly or indirectly exercising control. The supervisory authority determines the content and format of this information.

Portfolio transfer

Essential criteria

j. The supervisory authority requires that insurers get approval from the authority before they transfer all or any part of their insurance business.

k. The supervisory authority establishes requirements to assess insurers' applications to transfer all or any part of their insurance business.

l. The supervisory authority requires that the interests of the policyholders of both the transferee and transferor be protected when insurance business is transferred (refer to ICP 15 EC c).

ICP 9	**Corporate governance**
	The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.

Explanatory note

9.1. Insurers must be managed prudently. Corporate governance refers to the manner in which boards of directors and senior management oversee the insurers' business. It encompasses the means by which members of the board and senior management are held accountable and responsible for their actions. Corporate governance includes corporate discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. Timely and accurate disclosure on all material matters regarding the insurer, including the financial situation, performance, ownership and governance arrangements, is part of a corporate governance framework. Corporate governance also includes compliance with legal and regulatory requirements.

9.2. The board is the focal point of the corporate governance system. It is ultimately accountable and responsible for the performance and conduct of the insurer. Delegating authority to board committees or management does not in any way mitigate or dissipate the discharge by the board of directors of its duties and responsibilities. In the case of a policy established by the board, the board would need to be satisfied that the policy has been implemented and that compliance has been monitored. Similarly the board needs to be satisfied that applicable laws and regulations have been complied with. The responsibilities of the governing body must be consistent with the rules on governance structure established in the jurisdiction. Where the posts of chairman and chief executive are combined in one

person, the supervisory authority will verify that appropriate controls are in place to ensure that management is sufficiently accountable to the board of directors.

9.3. In most jurisdictions corporate governance rules exist for general purpose corporations; these likely also apply to insurers. Often, however, it is necessary to establish additional requirements, through the insurance legislation, that deal with the matters of specific concern and importance to insurance supervisors. These matters are described in the criteria below. As the supervisory authority may not have the power to specify the details of general corporate governance rules or to enforce compliance, several criteria under this principle refer to the responsibility of the board of directors rather than requirements from the supervisory authority.

Essential criteria

a. The supervisory authority requires and verifies that the insurer complies with applicable corporate governance principles.

b. The board of directors:

- sets out its responsibilities in accepting and committing to the specific corporate governance principles for its undertaking. Regulations on corporate governance should be covered in general company law and/or insurance law. These regulations should take account of the size, nature and complexity of the insurer.
- establishes policies and strategies, the means of attaining them, and procedures for monitoring and evaluating the progress toward them. Adherence to the policies and strategies are reviewed regularly, and at least annually.
- satisfies itself that the insurer is organised in a way that promotes the effective and prudent management of the institution and the board's oversight of that management. The board of directors has in place and monitors independent risk management functions that monitor the risks related to the type of business undertaken. The board of directors establishes audit functions, actuarial functions, strong internal controls and applicable checks and balances.
- distinguishes between the responsibilities, decision-making, interaction and cooperation of the board of directors, chairman, chief executive and senior management. The board of directors delegates its responsibilities and establishes decision-making processes. The insurer establishes a division of responsibilities that will ensure a balance of power and authority, so that no one individual has unfettered powers of decision.
- establishes standards of business conduct and ethical behaviour for directors, senior management and other personnel. These include policies on private transactions, self-dealing, preferential treatment of favoured internal and external entities, covering trading losses and other inordinate trade practices of a non-arm's length nature. The insurer has an on-going, appropriate and effective process of ensuring adherence to those standards.
- appoints and dismisses senior management. It establishes a remuneration policy that is reviewed periodically. This policy is made available to the supervisory authority.
- collectively ensures that the insurer complies with all relevant laws, regulations and any established codes of conduct (refer to EC f).
- has thorough knowledge, skills, experience and commitment to oversee the insurer effectively (refer to ICP 7).
- is not subject to undue influence from management or other parties. The board of directors has access to information about the insurer, and asks and receives additional information and analyses that the board sees fit.
- communicates with the supervisory authority as required and meets with the supervisory authority when requested.
- sets out policies that address conflicts of interest, fair treatment of customers and information sharing with stakeholders, and reviews these policies regularly (refer to ICP 25).

c. Senior management is responsible for:
- overseeing the operations of the insurer and providing direction to it on a day-to-day basis, subject to the objectives and policies set out by the board of directors, as well as to legislation.
- providing the board of directors with recommendations, for its review and approval, on objectives, strategy, business plans and major policies that govern the operation of the insurer.
- providing the board with comprehensive, relevant and timely information that will enable it to review business objectives, business strategy and policies, and to hold senior management accountable for its performance.

Advanced criteria

d. The board of directors may establish committees with specific responsibilities like a compensation committee, audit committee or risk management committee.

e. The remuneration policy for directors and senior management has regard to the performance of the person as well as that of the insurer. The remuneration policy should not include incentives that would encourage imprudent behaviour.

f. The board of directors identifies an officer or officers with responsibility for ensuring compliance with relevant legislation and required standards of business conduct and who reports to the board of directors at regular intervals (refer to EC b).

g. When a "responsible actuary" is part of the supervisory process, the actuary has direct access to the board of directors or a committee of the board. The actuary reports relevant matters to the board of directors on a timely basis.

ICP 10	**Internal control**
	The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.

Explanatory note

10.1. The purpose of internal control is to verify that:
- the business of an insurer is conducted in a prudent manner in accordance with policies and strategies established by the board of directors (refer to ICP 9)
- transactions are only entered into with appropriate authority
- assets are safeguarded (refer to ICP 21)
- accounting and other records provide complete, accurate, verifiable and timely information
- management is able to identify, assess, manage and control the risks of the business and hold sufficient capital for these risks (refer to ICP 18 and 23).

10.2. A system of internal control is critical to effective risk management and a foundation for the safe and sound operation of an insurer. It provides a systematic and disciplined approach to evaluating and improving the effectiveness of the operation and assuring compliance with laws and regulations. It is the responsibility of the board of directors to develop a strong internal control culture within its organisation, a central feature of which is the establishment of systems for adequate communication of information between levels of management.

10.3. It is an essential element of an internal control system that the board of directors receive regular reporting on the effectiveness of the internal control. Any identified weakness should be reported to the board of directors as soon as possible so appropriate action can be taken.

Essential criteria

a. The supervisory authority reviews the internal controls and checks their adequacy to the nature and the scale of the business and requires strengthening of these controls where necessary. The board of directors is ultimately responsible for establishing and maintaining an effective internal control system.

b. The framework for internal controls within the insurer includes arrangements for delegating authority and responsibility, and the segregation of duties. The internal controls address checks and balances; e.g. cross-checking, dual control of assets, double signatures (refer to ICP 9 EC b).

c. The internal and external audit, actuarial and compliance functions are part of the framework for internal control, and must test adherence to the internal controls as well as to applicable laws and regulations.

d. The board of directors must provide suitable prudential oversight and establish a risk management system that includes setting and monitoring policies so that all major risks are identified, measured, monitored and controlled on an on-going basis. The risk management systems, strategies and policies are approved and periodically reviewed by the board of directors (refer to ICP 18).

e. The board of directors provides suitable oversight of market conduct activities.

f. The board of directors should receive regular reporting on the effectiveness of the internal controls. Internal control deficiencies, either identified by management, staff, internal audit or other control personnel, are reported in a timely manner and addressed promptly.

g. The supervisory authority requires that internal controls address accounting procedures, reconciliation of accounts, control lists and information for management.

h. The supervisory authority requires oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the normal standards of internal controls.

i. The supervisory authority requires the insurer to have an on-going internal audit function of a nature and scope appropriate to the business. This includes ensuring compliance with all applicable policies and procedures and reviewing whether the insurer's policies, practices and controls remain sufficient and appropriate for its business.

j. The supervisory authority requires that an internal audit function:
   - has unfettered access to all the insurer's business lines and support departments
   - assesses outsourced functions
   - has appropriate independence, including reporting lines to the board of directors
   - has status within the insurer to ensure that senior management reacts to and acts upon its recommendations
   - has sufficient resources and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing

– employs a methodology that identifies the key risks run by the institution and allocates its resources accordingly (refer to ICP 18).

k. The supervisory authority has access to reports of the internal audit function.

l. Where the appointment of an actuary is called for by applicable legislation or by the nature of the insurer's operations, the supervisory authority requires that actuarial reports be made to the board and to management.

5. On-going supervision

ICP 11	**Market analysis**
	Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and insurance markets. It draws conclusions and takes action as appropriate.

Explanatory note

11.1. In order to achieve its objectives, the supervisory authority supervises the financial soundness of individual insurers and contributes to financial stability of the insurance market. Both require an analysis of individual insurers and insurance groups as well as the market and the environment in which they operate.

11.2. In today's globalised financial markets and rapidly integrating financial systems, economic developments and policy decisions of one jurisdiction may affect many other jurisdictions. Similarly, developments in the economy as a whole, or in one part of the financial sector, may impact the business operations and financial stability of the insurance market. To enable an assessment of financial data, it will be necessary to have an understanding of the basis of financial reporting in relevant jurisdictions.

11.3. In-depth market analysis helps identify risks and vulnerabilities, supports prompt supervisory intervention as referred in ICP 14 and strengthens the supervisory framework with a view to reducing the likelihood or severity of future problems. It is recognised that in-depth market analysis requires skilled resources.

11.4. A quantitative analysis of the market could include, for example, developments in the financial markets generally; the number of insurers and reinsurers subdivided by ownership structure whether a branch, domestic or foreign; the number of insurers and reinsurers entering and exiting the market; market indicators such as premiums, balance sheet totals and profitability; investment structure; new product developments and market share; distribution channels; and use of reinsurance.

11.5. A qualitative analysis could include, for example, reporting on general developments which may impact insurance markets, companies and clients; new or forthcoming financial sector and other relevant legislation; developments in supervisory practices and approaches; and reasons for market exits.

Essential criteria:

a. The supervisory authority conducts regular analysis of market conditions.

b. The market analysis not only includes past developments and the present situation, but also aims to identify trends and possible future scenarios and issues, so that the supervisory authority is well prepared to take action at an early stage, if required.

c. The market analysis is both quantitative and qualitative and makes use of both public and confidential sources of information.

d. The supervisory authority or others, such as the insurance industry, publish aggregated market data that is readily and publicly available to the insurance industry and other interested parties.

e. The supervisory authority requires market-wide systematic reporting to analyse and monitor particular market-wide events of importance for the financial stability of insurance markets.

Advanced criteria:

f. Insofar as international relationships affect internal insurance and financial markets, the analysis is not limited to the home market, but also includes developments elsewhere.

g. The supervisory authority monitors trends that may have an impact on the financial stability of insurance markets. It assesses whether macro-economic risks and vulnerabilities are adversely impinging on prudential safeguards, financial stability or consumer interests.

ICP 12	**Reporting to supervisors and off-site monitoring**
	The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.

Explanatory note

12.1. It is essential for the supervisory authority to receive information necessary to conduct effective off-site monitoring which can often identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious.

12.2. The supervisory authority decides what information it requires, in what form, from whom, and with what frequency. The reporting requirements are a reflection of the supervisory needs, and will thus vary according to overall market structure and situation. They also reflect the situation at individual insurers and the way they control their risks (e.g., asset/liability management, reinsurance policy.). Information should be both current and prospective in nature. In setting the requirements the supervisory authority should strike a balance between the need for information for supervisory purposes and the administrative burden it puts on insurers.

12.3. Reporting requirements should apply to all insurers licensed in a jurisdiction and form the general basis for off-site analysis. The reporting requirements should be reviewed periodically. Additional information may be requested from specific insurers on a case-by-case basis. New developments may require the supervisory authority to carry out market-wide off-site analyses, which will require having insurers to submit information on an ad-hoc basis.

12.4. In setting the requirements, the supervisory authority may make a distinction between the standards applied to reports prepared for disclosure to policyholders and investors, and those applied for the supervisory authority.

12.5. In setting the requirements, the supervisory authority may make a distinction between the financial reports and calculations prepared for companies incorporated in its jurisdiction, and branch operations in its jurisdiction of companies incorporated in another jurisdiction.

Essential criteria:

a. The supervisory authority:
- sets the requirements for the submission of regular and systematic financial and statistical information, actuarial reports and other information from all insurers licensed in the jurisdiction
- defines the scope and frequency of those reports and information, including any requirement that reports and information be audited
- requires, as a minimum, an audit opinion should be provided annually (refer to ICP 1 EC e)
- requests more frequent and more detailed additional information whenever there is a need.

b. If making a distinction between the financial reports and requirements of companies incorporated in the jurisdiction and branches, or between private entities and government-sponsored insurers that compete with private enterprises, the supervisory authority should not distort the market in favour of or against any particular form of enterprise.

c. The supervisory authority:
- requires insurers to submit information about their financial condition and performance on both a solo and a group-wide basis. It may request and obtain financial information on any subsidiary of the supervised entity.
- sets out the principles and norms regarding accounting and consolidation techniques to be used. The valuation of assets and liabilities should be consistent, realistic, and prudent (refer to ICP 21 EC b).
- requires insurers to report any off-balance sheet exposures.
- requires insurers to report on their outsourced functions.
- requires that the appropriate level of an insurer's senior management is responsible for the timing and accuracy of these returns.
- requires that inaccurate information be corrected and has the authority to impose sanctions for deliberate misreporting.
- based on this information, maintains a framework for on-going monitoring of the financial condition and performance of the insurers.

Advanced criteria

d. From time to time, the supervisory authority reviews its regular and systematic reporting requirements to ensure they still serve their intended aims and are carried out in an efficient and effective manner.

e. The supervisory authority requires insurers to report promptly material changes that affect the evaluation of their condition.

ICP 13	**On-site inspection**
	The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

Explanatory note

13.1. Whether performed by the staff of the supervisory authority or other suitably qualified specialists, on-site 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. On-site inspection, however, also needs the support of market information and statistics derived from the analysis of the annual accounts and returns.

13.2. Through on-site inspections the supervisory authority is able to verify or capture reliable data and information to assess and analyse an insurer's current and prospective solvency. On-site inspection enables the supervisor to obtain information and detect problems that cannot be easily obtained or detected through on-going monitoring. In particular, on-site 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[4], strategic and operational direction, reinsurance, and risk management.

13.3. On-site 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 analyse the impact of specific regulations and, more generally, to gather information for benchmarking.

13.4. The criteria envisage that on-site inspection may be carried out in a manner that is either "full scale" or "on a focussed basis." Both forms of inspection need to be conducted by skilled staff that can evaluate and analyse the information that they obtain during the inspection. Usually the supervisory authority provides guidance on the scope and procedures for on-site inspections. However, staff performing inspections should use their investigative and technical skills when forming views about the information they obtain.

13.5. On-site inspection can assist in assessing the risks to which a firm is exposed. A full-scale on-site 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, e.g. the type of business written
- evaluation of the technical conduct of insurance business or an evaluation of the organisation 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 on-site 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

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[4] The term "technical provisions" is used throughout this document. Some jurisdictions use the term "policy liabilities" instead. The meaning is the same, i.e., amount set aside on the balance sheet to meet liabilities arising out of insurance contracts, including claims provision (whether reported or not), provision for unearned premiums, provision for unexpired risks, life assurance provision and other liabilities related to life insurance contracts (e.g. premium deposits, savings accumulated over the term of with–profit policies) (source: IAIS Glossary of Terms).

- reviewing the frequency and nature of litigation
- assessing observance of the market conduct standards and consumer regulations (refer to ICP 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 on-site inspections will take account of the risk profile of the insurer as it appears from previous on-site inspections and off-site 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 on-site 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 on-site 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 on-site inspections on either a full scale, or a focussed 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 on-site inspections to obtain information from intermediaries and companies that have accepted functions outsourced by the supervised insurer.

ICP 14 Preventive and corrective measures

The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.

Explanatory note

14.1. Where insurers fail to meet supervisory requirements or where their continued solvency comes into question, the supervisory authority must intervene to protect policyholders. To do so, the supervisor authority needs to have the legal and operational capacity to bring about timely corrective action. Depending on the nature of the problem detected, a graduated response may be required. In instances where the detected problem is relatively minor, informal action such as an oral or written communication to management may be sufficient. In other instances, more formal action may be necessary.

Essential criteria:

a. The supervisory authority has available and makes use of adequate instruments to enable timely preventive and corrective measures if an insurer fails to operate in a manner that is consistent with sound business practices or regulatory requirements.

b. There should be a progressive escalation of action or remedial measures if the problems become worse or if management of the insurer ignores more informal requests from the supervisory authority to take corrective action.

c. The supervisory authority has the capacity and standing to communicate with insurers, and insurers comply with such communications, to ensure that relatively minor preventive or corrective measures are taken.

d. If necessary the supervisory authority requires the insurer to develop an acceptable plan for correction of problems. Corrective plans include agreed and acceptable steps to be taken to resolve the issues raised and an acceptable timetable.

e. The supervisory authority initiates measures designed to prevent a breach of the legislation from occurring, and promptly and effectively deals with non-compliance with regulations that could put policyholders at risk or impinge on any other of the authority's objectives.

ICP 15	**Enforcement or sanctions**
	The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.

Explanatory note

15.1. The supervisory authority must have the power to take remedial action in a timely manner where problems involving licensed insurers are identified. The decision-making lines of the supervisory authority should be structured so that action can be taken immediately in the case of an emergency situation (refer to ICP 4 EC e).

15.2. The supervisory authority must have a range of actions available in order to apply appropriate enforcement or sanctions where problems are encountered. Powers should be set out in legislation and may include:

- restricting business activities
- stopping the writing of new business
- withholding approval for new activities or acquisitions
- directing the insurer to stop practices that are unsafe or unsound
- putting assets of the insurer in trust or restricting disposal of those assets
- revoking the licence of an insurer
- removing directors and managers
- barring individuals from the business of insurance.

15.3. In some cases it may be appropriate to apply punitive sanctions against insurers or individuals. Provided that the policyholders are not put at greater risk, provisions would normally apply to such situations that would permit a right of appeal of decisions. For actions taken in good faith while discharging their duties the law provides legal protection to the supervisory authority and its staff against lawsuits (refer to ICP 3).

15.4. This principle is directed at the overall protection of policyholders and the observance of requirements. Matters involving individual customers are subject to ICP 25.

Essential criteria:

a. The supervisory authority can issue formal directions to companies to take particular actions or to desist from taking particular actions. Failure to comply with a formal direction issued by the supervisory authority has serious consequences for those that take such a step.

b. The supervisory authority has the power to prevent the insurer issuing new policies.

c. The supervisory authority can arrange for compulsory transfer of the obligations under the policies from a failing insurer to another insurer that accepts this transfer (refer to ICP 8 EC l).

d. The supervisory authority can require capital levels to be increased, restrict or suspend dividend or other payments to shareholders, restrict asset transfers and restrict an insurer's purchase of its own shares. It can also initiate action to restrict the ownership or activities of a subsidiary where, in its opinion, such activities jeopardise the financial situation of the insurer.

e. The supervisory authority has effective means to address management problems, including the power to have controlling owners, directors, and managers replaced or their powers restricted. More generally the supervisory authority in extreme cases, imposes conservatorship over an insurer that is failing to meet prudential or other requirements. The supervisory authority has the power to take control of the insurer, or to appoint other specified officials or receivers for the task, and to make such arrangements for the benefit of the policyholders as are necessary.

f. Once action has been taken or remedial measures have been imposed, the supervisory authority periodically checks to determine that the insurer is complying with the measures.

g. The insurance legislation provides for sanctions by way of fines against individuals and insurers where the provisions of the legislation are breached.

h. The insurance legislation provides for sanctions against individuals who withhold information from the supervisory authority, provide information that is intended to mislead the supervisory authority or fail to provide information to the supervisory authority in a timely fashion.

i. Individuals can be barred from acting in responsible capacities in the future.

j. The process of applying sanctions should not delay necessary preventive and corrective measures and enforcement.

k. The supervisory authority takes action to withdraw the license of an insurer where appropriate.

l. The supervisory authority has the powers to protect one or more insurers within its jurisdiction that belong to a group from the financial difficulties in other parts of the group.

m. The supervisory authority, or another responsible body in the jurisdiction, takes action to enforce all the sanctions noted above.

n. The supervisory authority ensures consistency in the way insurers are sanctioned, so that similar violations and weaknesses attract similar preventive and corrective measures.

o. The supervisory authority or other authority takes action against those individuals or entities that are operating an insurance business without a licence.

ICP 16 Winding-up and exit from the market

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.

Explanatory note

16.1. An insurer may no longer be financially viable or may be insolvent. In such cases, the supervisory authority can be involved in resolutions that require a take-over by or merger with a healthier institution. When all other measures fail, the supervisory authority should have the ability to close or assist in the closure of the troubled insurer.

16.2. The legislation should establish the priority that policyholders receive in winding-up an insurer. However, it is also common in many jurisdictions that priority is given to other stakeholders, such as employees or the fiscal authorities. In some jurisdictions, a policyholder protection fund provides additional or alternative protection. Some jurisdictions may decide that protection provided through a policyholder protection fund is not necessary for commercial policyholders.

Essential criteria:

a. The legal and regulatory framework provides for the determination of the point at which it is no longer permissible for an insurer to continue its business.

b. The procedures for dealing with insolvency and the winding-up of the insurer are clearly set forth in the law.

c. A high legal priority is given to the protection of the rights and entitlements of policyholders and other policy beneficiaries in the event of an insurer becoming insolvent and winding-up. This priority ensures that, as far as is practical, there is limited disruption to the provision of benefits to policyholders.

ICP 17 Group-wide supervision

The supervisory authority supervises its insurers on a solo and a group-wide basis.

Explanatory note

17.1. Supervision of insurers, who are part of a wider insurance group or conglomerate, whether domestic or international, should not be limited to the solo supervision of that insurer. The operations of other group companies, including any holding companies if applicable, are taken into account in assessing the totality of the risk exposures of the insurers, insurance groups and conglomerates. The fact that such an insurer is part of a group generally alters, often considerably, its risk profile, its financial position, the role of its management, and its business strategy. As a consequence, there should be legal provisions and effective supervision that adequately meet the changed profile of the insurer, ensuring adequate group wide assessment and supervisory action as appropriate.

17.2. As a first step, there should be legal certainty for all parties involved about what constitutes an insurance group or conglomerate. For entities that are considered to be part of such a group, a group mapping exercise should be undertaken that delineates the group structure, and identifies the supervisory authorities involved. Supervisory tasks for the group and the constituent parts should be agreed upon by the supervisors involved or may be set out in legislation. This may call for further co-operation agreements between the various supervisory authorities often including supervisory authorities from different jurisdictions and financial sectors.

17.3. Group-wide assessment and supervision should not be limited to financial indicators such as capital adequacy and risk concentration, but also the management structure, fit and proper testing, and legal issues. The groups should have information systems in place not only to serve their internal information needs, but also to provide all information that the supervisory authority may require in an adequate and timely manner.

17.4. The effective supervision of groups may require effort to ensure that the necessary supervisory tools such as information collection and on-site inspections are able to address group-wide issues effectively.

Essential criteria:

a. What constitutes an insurance group and financial conglomerate is clearly defined so that supervisors and insurers can determine:
   - which groups are considered to be insurance groups or financial conglomerates
   - which group or groups an insurer belongs to
   - the scope of the supervision.

b. The supervisory authority ensures effective and efficient group-wide supervision. The supervisory authorities co-operate to avoid unnecessary duplication.

c. Where different supervisory authorities are responsible for different parts of a group or conglomerate appropriate co-operation and co-ordination exists. The supervisory responsibilities of each authority are well-defined and leave no supervisory gaps.

d. At a minimum, group-wide supervision of insurers which are part of insurance groups or financial conglomerates includes, as a supplement to solo supervision, at a group level, and intermediate level as appropriate, adequate policies on and supervisory oversight of:
   - group structure and interrelationships, including ownership and management structure
   - capital adequacy
   - reinsurance and risk concentration
   - intra-group transactions and exposures, including intra-group guarantees and possible legal liabilities
   - internal control mechanisms and risk management processes, including reporting lines and fit and proper testing of senior management.

e. Host supervisory authorities avoid uncooperative behaviour with home supervisory authorities so as not to hinder effective supervision of groups and conglomerates (refer to ICP 5 EC i).

f. The supervisory authority requires that insurance groups and financial conglomerates have reporting systems in place that adequately meet the supervisory information demands.

g. The supervisory authority may deny or withdraw the license when the organisational (or group) structure hinders effective supervision (refer to ICP 6 and ICP 15).

6. Prudential requirements

15. This section sets out six principles addressing prudential requirements. Their common goal is to ensure that insurers have the ability under all reasonably foreseeable circumstances to fulfil their obligations as they fall due.

ICP 18	**Risk assessment and management**
	The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively.

Explanatory note

18.1. An insurer should identify, understand, and manage the significant risks that it faces. Effective and prudent risk management systems appropriate to the complexity, size and nature of the insurer's business should identify and measure against risk tolerance limits the risk exposure of the insurer on an on-going basis in order to indicate potential risks as early as possible. This may include looking at risks by territory or by line of business.

18.2. Some risks are specific to the insurance sector, such as underwriting risks and risks related to the evaluation of technical provisions. Other risks are similar to those of other financial institutions, for example market (including interest rate), operational, legal, organisational and conglomerate risks (including contagion, correlation and counter-party risks).

18.3. Supervisors play a critical role in the risk management process by reviewing the monitoring and controls exercised by the insurer. The supervisory authority develops prudential regulations and requirements to contain these risks. While the supervisor puts such requirements in place with the intention of ensuring enhanced practices by insurers, the ultimate responsibility for the development of best practices and the proper operation of the insurer must always rest with the board of directors.

Essential criteria

a. The supervisory authority requires and checks that insurers have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling their risks (refer to ICP 10 EC d).

b. The risk management policies and risk control systems are appropriate to the complexity, size and nature of the insurer's business. The insurer establishes an appropriate tolerance level or risk limit for material sources of risk.

c. The risk management system monitors and controls all material risks.

d. Insurers regularly review the market environment in which they operate, draw appropriate conclusions as to the risks posed and take appropriate actions to manage adverse impacts of the environment on the insurer's business.

Advanced criteria

e. Larger insurers establish a risk management function and a risk management committee.

ICP 19 Insurance activity

Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums.

Explanatory note

19.1. Insurers take on risks and manage them through a range of techniques including pooling and diversification. Every insurer should have an underwriting policy that is approved and monitored by the board of directors.

19.2. Insurers use actuarial, statistical, or financial methods for estimating liabilities and determining premiums. If these amounts are materially understated, the consequences for the insurer can be significant and in some cases fatal. In particular, premiums charged could be inadequate to cover the risk and costs, insurers may pursue lines of business that are not profitable, and liabilities may be understated, masking the true financial state of the insurer. There is a need to ensure that embedded options have been identified, properly priced and an appropriate reserve has been established.

19.3. Insurers use a number of tools to mitigate and diversify the risks they assume. The most important tool to transfer risk is reinsurance. An insurer should have a reinsurance strategy, approved by its board, that is appropriate to its overall risk profile and its capital. The reinsurance strategy will be part of the insurer's overall underwriting strategy.

Essential criteria

a. The supervisory authority requires insurers to have in place strategic underwriting and pricing policies approved and reviewed regularly by the board of directors.

b. The supervisory authority checks that insurers evaluate the risks that they underwrite and establish and maintain an adequate level of premiums. For this purpose, insurers should have systems in place to control their expenses related to premiums and claims, including claims handling and administration expenses. These expenses should be monitored by management on an on-going basis.

c. The supervisory authority is able to review the methodology used by the insurer to set premiums to determine that they are established on reasonable assumptions to enable the insurer to meet its commitments.

d. The supervisory authority requires that the insurer has a clear strategy to mitigate and diversify risks by defining limits on the amount of risk retained and taking out appropriate reinsurance cover or using other risk transfer arrangements consistent with its capital position. This strategy is an integral part of the insurer's underwriting policy and must be approved and regularly monitored and reviewed by the board of directors.

e. The supervisory authority reviews reinsurance arrangements to check that they are adequate and that the claims held by insurers on their reinsurers are recoverable. This includes that:

- the reinsurance programme provides coverage appropriate to the level of capital of the insurer (taking into account the real transfer of risk) and the profile of the risks it underwrites
- the reinsurer's protection is secure. This might be addressed through different means, such as relying on a system of direct supervision of reinsurers or obtaining collateral (including trusts, letters of credit or funds withheld).

f. The supervisory authority checks that risk transfer instruments are properly accounted for in order to give a true and fair view of the insurer's risk exposure.

ICP 20 Liabilities

The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.

Explanatory note

20.1. An insurer must identify and quantify its existing and anticipated obligations. The establishment of sufficient technical provisions, that is the amount set aside on the balance sheet to meet obligations arising out of insurance contracts (including any related administration expenses, embedded options, policyholder dividends or bonuses and taxes) is a cornerstone of a sound capital adequacy and solvency regime.

20.2. Standards should be defined to be followed by the insurers in setting up their liabilities and, in particular, their technical provisions. These standards should address what is to be included as liabilities; for example, claims provisions – including provisions for claims incurred but not reported, provisions for unearned premiums, provisions for unexpired risks, life insurance provisions and any other liabilities or technical provisions. These standards should also be consistent with other components of the solvency regime. The standards should ensure the that technical provisions are sufficient to cover all expected and some unexpected claims and expenses, make use of reliable and objective methods, and allow a comparison across insurers. The supervisors must have both the power and the ability to check the adequacy of the technical provisions vis-à-vis the established standards and to require the provisions to be increased if, in the supervisor's opinion, these are not sufficient. This part of the supervisory process requires the use of appropriate actuarial skills.

Essential criteria

a. Legal provisions are in place for establishing adequate technical provisions and other liabilities based on sound accounting and actuarial principles.

b. The supervisory authority prescribes or agrees to standards for establishing technical provisions and other liabilities.

c. The supervisory authority in developing the standards considers:
- what is to be included as a liability
- the procedure and the internal control system that are in place to ensure reliable data (refer to ICP 10)
- the methods and assumptions for assessing, on a reliable, objective, transparent and prudent basis, technical provisions to cover all expected and some unexpected claims and expenses.

d. The supervisory authority reviews the sufficiency of the technical provisions through off-site monitoring and on-site inspection (refer to ICPs 12 and 13).

e. The supervisory authority requires the technical provisions to be increased if they are not sufficient.

f. The supervisory authority ensures that standards stipulate:
- general limits for the valuation of the amounts recoverable under reinsurance arrangements with a given reinsurer for solvency purposes, taking into account the ultimate collectability and the real transfer of risk
- sound accounting principles for the booking of the amounts recoverable under reinsurance arrangements
- the credit for technical provisions for amounts recoverable under reinsurance arrangements. In that case, the amount recoverable is disclosed in the financial statement of the insurer by reporting the respective gross and net figures in the accounts.

Advanced criteria

g. The supervisory authority requires that insurers undertake regular stress testing for a range of adverse scenarios in order to assess the adequacy of capital resources in case technical provisions have to be increased (refer to ICP 21 AC k and ICP 23 AC j).

ICP 21 Investments

The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.

Explanatory note

21.1. Insurers must manage their investments in a sound and prudent manner. An investment portfolio carries a range of investment-related risks that might affect the coverage of technical provisions and the solvency margin. Insurers need to identify, measure, report and control the main risks.

21.2. For insurers in many jurisdictions concentration risk arising from the limited availability of suitable domestic investment vehicles is a real problem. By contrast, international insurers' investment strategies are potentially complex because often they need to manage and match assets and liabilities in a number of currencies and different markets. In addition, the need for liquidity resulting from potential large-scale payments may further complicate an insurer's investment strategy.

21.3. The supervisory authority ensures that standards are established for insurers in managing their investment portfolios and inherent risks. The supervisory authority needs to have both the authority and ability to assess these risks and their potential impact on technical provisions and solvency. However, the detailed formulation of an insurer's investment management policy and internal risk control methodology is the responsibility of the board of directors.

Essential criteria

a. Requirements regarding the management of investments are in place, either in the law or in supervisory rules. These requirements address, but may not be limited to, the following:
- the mixture and diversification by type

- limits or restrictions on the amount that may be held in particular types of financial instruments, property, and receivables
- the safekeeping of assets
- the appropriate matching of assets and liabilities
- the level of liquidity.

b. Investments are valued according to a method prescribed by or acceptable to the supervisory authority.

c. The supervisory authority requires insurers to have in place an overall strategic investment policy, approved and reviewed annually by the board of directors, that addresses the following main elements:
- the risk profile of the insurer
- the determination of the strategic asset allocation, that is, the long-term asset mix over the main investment categories
- the establishment of limits for the allocation of assets by geographical area, markets, sectors, counterparties and currency
- the extent to which the holding of some types of assets is restricted or disallowed, for example illiquid or volatile assets or derivatives
- the conditions under which the insurer can pledge or lend assets
- an overall policy on the use of financial derivatives and structured products that have the economic effect of derivatives (refer to ICP 22)
- clear accountability for all asset transactions and associated risks.

d. The risk management systems must cover the risks associated with investment activities that might affect the coverage of technical provisions and/or solvency margins (capital). The main risks include:
- market risk
- credit risk
- liquidity risk
- failure in safe keeping of assets (including the risk of inadequate custodial agreements).

e. The supervisory authority checks that insurers have in place adequate internal controls to ensure that assets are managed in accordance with the overall investment policy, as well as in compliance with legal, accounting, and regulatory requirements. These controls should ensure that investment procedures are documented and properly overseen. Normally the functions responsible for measuring, monitoring, settling and controlling asset transactions are separate from the front office functions (refer to ICP 10).

f. The supervisory authority requires that oversight of, and clear management accountability for, an insurer's investment policies and procedures remain ultimately with the board of directors, regardless of the extent to which associated activities and functions are delegated or outsourced.

g. The supervisory authority requires that key staff involved with investment activities have the appropriate levels of skills, experience and integrity.

h. The supervisory authority requires that insurers have in place rigorous audit procedures that include full coverage of their investment activities to ensure the timely identification of internal control weaknesses and operating system deficiencies. If the audit is performed internally it should be independent of the function being reviewed.

i. The supervisory authority requires that insurers have in place effective procedures for monitoring and managing their asset/liability position to ensure that their investment activities and asset positions are appropriate to their liability and risk profiles.

j. The supervisory authority requires that insurers have in place contingency plans to mitigate the effects of deteriorating conditions.

Advanced criteria

k. The supervisory authority requires that insurers undertake regular stress testing for a range of market scenarios and changing investment and operating conditions in order to assess the appropriateness of asset allocation limits (refer to ICP 20 AC g and ICP 23 AC j).

ICP 22	**Derivatives and similar commitments**
	The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.

Explanatory note

22.1. A derivative is a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indices (the "underlying asset"). Derivatives are financial contracts and include a wide assortment of instruments, such as forwards, futures, options, warrants, and swaps. These features can be embedded in hybrid instruments (e.g., a bond whose maturity value is tied to an equity index is a hybrid instrument that contains a derivative). Insurers choosing to engage in derivative activities should clearly define their objectives, ensuring that these are consistent with any legislative restrictions.

22.2. Given the nature of insurance operations, derivatives should be used preferably as a risk mitigation mechanism. Supervisory authorities may restrict the use of derivatives to the reduction of investment risk or efficient portfolio management. Derivatives should be considered in the context of a prudent overall asset/liability management strategy.

22.3. This principle also applies to financial instruments that have the economic effect of derivatives and could apply to commodity derivatives, where insurers are permitted to engage in these transactions. Where a jurisdiction completely prohibits the use of derivatives and similar commitments then the assessment criteria clearly do not apply. The prohibition of the use of derivatives is particularly appropriate where a jurisdiction does not fully observe the conditions for effective supervision (refer to ICP 1).

22.4. The criteria of transparent and structured decision-making procedures of policy-setting, execution, monitoring, reporting and control apply equally to similar commitments that are not derivatives transactions but which may be included in some jurisdictions as 'off-balance sheet' items. Equivalent requirements and controls should be in place for commitments transacted through special purpose vehicles.

22.5. Derivatives, used appropriately, can be useful tools in the reduction of portfolio risk of insurers. In monitoring the activities of insurers involved in derivatives, the supervisory authority must satisfy itself that insurers have the ability to recognise, measure, and prudently manage the risks associated with their use. The supervisory authority should obtain sufficient information on insurers' policies and

procedures on the use of derivatives and may request information on the purpose for which particular derivatives are to be used and the rationale for undertaking particular transactions.

Essential criteria

a. Requirements regarding the use of derivatives are in place, either in the law or in supervisory rules. The requirements consider the risks in the use of derivatives and similar commitments.

b. The supervisory authority establishes disclosure requirements for derivatives and similar commitments.

c. The supervisory authority requires the board of directors to satisfy itself that collectively the board has sufficient expertise to understand the important issues related to the use of derivatives, and that all individuals conducting and monitoring derivatives activities are suitably qualified and competent.

d. The supervisory authority requires insurers using derivatives to have in place an appropriate policy for their use that must be approved and reviewed annually by the board of directors. This policy should be consistent with the insurer's activities, its overall strategic investment policy and asset/liability management strategy, and its risk tolerance. It addresses at least the following elements:
   - the purposes for which derivatives can be used
   - the establishment of appropriately structured exposure limits for derivatives taking into account the purpose of their use and the uncertainty caused by market, credit, liquidity, operations and legal risk
   - the extent to which the holding of some types of derivatives is restricted or not authorised; for example, where the potential exposure cannot be reliably measured, the closing out or disposal of the derivative could be difficult due to its lack of marketability (as may be the case with over-the-counter instruments) or the illiquidity of the market, or where independent (i.e. external) verification of pricing is not available
   - the delineation of lines of responsibility and a framework of accountability for derivatives transactions.

e. The supervisory authority requires that insurers have in place risk management systems, covering the risks from derivatives activities to ensure that the risks arising from all derivatives transactions undertaken by the insurer can be:
   - analysed and monitored individually and in aggregate
   - monitored and managed in an integrated manner with similar risks arising from nonderivatives activities so that exposures can be regularly assessed on a consolidated basis.

f. The supervisory authority requires that insurers have in place adequate internal controls to ensure that derivatives activities are properly overseen and that transactions have been entered into only in accordance with the insurer's approved policies and procedures, and legal and regulatory requirements. These controls ensure appropriate segregation between those who measure, monitor, settle and control derivatives and those who initiate transactions (refer to ICP 10).

g. The supervisory authority requires that insurers have in place personnel with appropriate skills to vet models used by the front office and to price the instruments used, and that pricing follows market convention. These functions should also be separate from the front office.

h. The supervisory authority requires that the board of directors ensure that the insurer has the appropriate capability to verify pricing independently where the use of 'over-the-counter' derivatives is permitted under the insurer's policy.

i. The supervisory authority requires that insurers have in place rigorous audit procedures that include coverage of their derivatives activities to ensure the timely identification of internal control weaknesses and operating system deficiencies. If the audit is performed internally it should be independent of the function being reviewed.

ICP 23 Capital adequacy and solvency

The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurer to absorb significant unforeseen losses.

Explanatory note

23.1. A sound solvency regime is essential to the supervision of insurance companies and the protection of policyholders. Capital adequacy requirements are part of a solvency regime. A solvency regime should take into account not only the sufficiency of technical provisions to cover all expected and some unexpected claims and expenses but also the sufficiency of capital to absorb significant unexpected losses - to the extent not covered by the technical provisions - on the risks for which capital is explicitly required. It should also require additional capital to absorb losses from risks not explicitly identified.

23.2. In order to protect policyholders from undue loss, it is necessary that a solvency regime establishes not only minimum capital adequacy requirements, but also a solvency control level, or series of control levels, which act as indicators or triggers for early supervisory action, before problems become serious threats to an insurer's solvency. The form of the solvency control level may be based on capital levels or other financial measures related to the solvency regime of the jurisdiction.

23.3. Any allowance for reinsurance in a capital adequacy and solvency regime should consider the effectiveness of the risk transfer and make allowance for the likely security of the reinsurance counterparty.

Essential criteria

a. The solvency regime addresses in a consistent manner:
   - valuation of liabilities, including technical provisions and the margins contained therein
   - quality, liquidity and valuation of assets
   - matching of assets and liabilities
   - suitable forms of capital
   - capital adequacy requirements.

b. Any allowance for risk mitigation or transfer considers both its effectiveness and the security of any counterparty.

c. Suitable forms of capital are defined.

d. Capital adequacy requirements are sensitive to the size, complexity and risks of an insurer's operations, as well as the accounting requirements that apply to the insurer.

e. The minimum capital adequacy requirements should be set at a sufficiently prudent level to give reasonable assurance that policyholder interests will be protected.

f. Capital adequacy requirements are established at a level such that an insurer having assets equal to the total of liabilities and required capital will be able to absorb significant unforeseen losses.

g. Solvency control levels are established. Where the solvency position reaches or falls below one or more control levels, the supervisory authority intervenes and requires corrective action by the insurer or imposes restrictions on the insurer. The control level is set so that corrective action can be taken in a timely manner (refer to ICP 14).

h. Inflation of capital – through double or multiple gearing, intra-group transactions, or other financing techniques available as a result of the insurer's membership in a corporate group – is addressed in the capital adequacy and solvency calculation (refer to ICP 17).

i. The solvency regime addresses the requirements placed upon an insurer operating through a branch.

Advanced criteria

j. The solvency regime provides for periodic, forward-looking analysis (e.g., dynamic solvency/ stress testing) of an insurer's ability to meet its obligations under various conditions (refer to ICP 20 AC g and ICP 21 AC k).

k. The supervisory authority assesses the structure of its solvency regime against structures of a peer group of jurisdictions and works towards achieving consistency.

7. Markets and consumers

16. The following principles address issues of market conduct that are an essential area of the supervision in the insurance sector, and may have a reputation risk or prudential impact on insurers.

ICP 24	**Intermediaries**
	The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.

Explanatory note

24.1. In many insurance markets, intermediaries serve as important distribution channels of insurance. They provide the interface between consumers and the insurer. Their good conduct is essential to protect consumers and promote confidence in insurance markets. For this reason, intermediaries should be directly or indirectly supervised. Where intermediaries are supervised directly, then the supervisory authority should be able to conduct on-site inspection when needed (refer to ICP 13 EC f).

24.2. Intermediaries include all those who are engaged in insurance intermediation activities.

Essential criteria

a. The supervisory authority requires intermediaries to be licensed or registered.

b. The supervisory authority requires intermediaries to have adequate general, commercial and professional knowledge and ability as well as having a good reputation.

c. If necessary, the supervisory authority takes corrective action, including applying sanctions, directly or through insurers, and cancelling the intermediary's licence or registration, when appropriate.

d. The supervisory authority requires an intermediary who handles client's money to have sufficient safeguards in place to protect these funds.

e. The supervisory authority requires intermediaries to give customers information on their status, specifically whether they are independent or associated with particular insurance companies and whether they are authorised to conclude insurance contracts on behalf of an insurer or not.

f. The supervisory authority or other authority must have powers to take action against those individuals or entities that are carrying on insurance intermediation activity without license or registration.

ICP 25 Consumer protection

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.

Explanatory note:

25.1. Requirements for the conduct of insurance business help to strengthen consumer confidence in the insurance market.

25.2. The supervisory authority requires insurers and intermediaries to treat their customers fairly, paying attention to their information needs. With respect to consumers in their own jurisdiction, the supervisory authority should set requirements with which insurers and intermediaries must comply. The requirements applicable to cross-border sales should also be clear.

25.3. A good claim resolution process is essential for the fair treatment of consumers. For this purpose, some jurisdictions have established extra judicial claim resolution mechanisms, such as independent panels or arbitrators.

25.4. For a large number of consumers, insurance products are difficult to understand and evaluate. Insurers and intermediaries have a greater knowledge of insurance issues than the consumers. Arrangements should therefore exist for potential policyholders:

- to have access to information needed to make an informed decision before entering into a contract
- to be informed about their rights and obligations for the duration of the contract

25.5. These requirements should distinguish between particular types of customers. In particular, detailed conduct of business rules may not be appropriate for reinsurance transactions or in respect of professional customers. Nonetheless this does not relieve reinsurers of their duty to provide complete and accurate information to the insurers with whom they deal.

Essential criteria

a. The supervisory authority requires insurers and intermediaries to act with due skill, care and diligence in their dealing with consumers.

b. The supervisory authority requires insurers and intermediaries to have policies on how to treat consumers fairly and to have systems and provide training to ensure compliance with those policies by their employees and other sales collaborators.

c. The supervisory authority requires insurers and intermediaries to seek the information from their consumers that is appropriate in order to assess their insurance needs, before giving advice or concluding a contract.

d. The supervisory authority sets requirements for insurers and intermediaries with regard to the content and timing of provision of information:
   - on the product, including the associated risks, benefits, obligations, and charges
   - on other matters related to the sale, including possible conflict of interest to existing or potential policyholders.

e. The supervisory authority requires insurers and intermediaries to deal with claims and complaints effectively and fairly through a simple, easily accessible and equitable process.

Advanced criteria

f. The supervisory authority requires insurers and intermediaries to set rules on the handling of customer information paying due regard to the protection of private information of customers.

g. The supervisory authority gives information to the public about whether and how local legislation applies to the cross-border offering of insurance, such as e-commerce. The supervisor issues warning notices to consumers when necessary in order to avoid transactions with unsupervised entities.

h. The supervisory authority promotes the consumers' understanding of the insurance contracts.

ICP 26	**Information, disclosure & transparency towards the market**
	The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.

Explanatory note

26.1. Public disclosure of reliable and timely information facilitates the understanding by prospective and existing stakeholders of the financial position of insurers and the risks to which they are subject, regardless of whether they are publicly traded or not.

26.2. Supervisory authorities are concerned with maintaining efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. When provided with appropriate information markets can act efficiently, rewarding those insurers that operate effectively and penalising those that do not. This aspect of market discipline serves as an adjunct to supervision.

26.3. Regular disclosure can facilitate the smooth functioning of the insurance markets. For example, when timely public disclosure exists market participants are less likely to overreact to negative information about an insurer.

26.4. Greater disclosure entails increased costs, which may be direct or indirect. For example, companies may experience a competitive disadvantage from increased disclosure of proprietary information. These costs must be weighed against the potential benefit of increased disclosure required by any standards.

26.5. The supervisory authority takes action, if necessary in coordination with other relevant bodies, to ensure effective and relevant disclosure.

Essential criteria

a. Insurers are required to disclose information on their financial position and the risks to which they are subject. Specifically, information disclosed should be:
- relevant to decisions taken by market participants
- timely so as to be available and up-to-date at the time those decisions are made
- accessible without undue expense or delay by the market participants
- comprehensive and meaningful so as to enable market participants to form a well-rounded view of the insurer
- reliable as a basis upon which to make decisions
- comparable between different insurers
- consistent over time so as to enable relevant trends to be discerned.

b. Information includes quantitative and qualitative information on:
- financial position
- financial performance

and a description of:
- the basis, methods and assumptions upon which information is prepared (and comments on the impact of any changes)
- risks exposures and how they are managed
- management and corporate governance.

c. Insurers are required to produce, at least annually, audited financial statements and make them available to stakeholders.

d. The supervisory authority monitors the information disclosed by insurers and takes the necessary actions to ensure the compliance with disclosure requirements.

Advanced criteria

e. Information includes quantitative information of relevant risk exposures.

ICP 27 Fraud

The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.

Explanatory note

27.1. The supervisory authority has an important role to play in combating fraud in insurance in its jurisdiction. It communicates with other supervisors in addressing such fraud across jurisdictions.

27.2. Fraud can be perpetrated by any party involved in insurance, e.g. insurers, insurers' managers and staff, intermediaries, accountants, auditors, consultants, claims adjusters as well as policyholders.

27.3. Most jurisdictions have legal provisions against fraud in insurance. In many jurisdictions, instances of fraud are criminal acts.

27.4. Fraud in insurance results in reputational as well as financial damage and social and economic costs. That is why the supervisory authority requires that insurers and intermediaries address it effectively.

Essential criteria

a. The supervisory authority has the powers and resources to establish and enforce regulations and to communicate as appropriate with enforcement authorities, as well as with other supervisors, to deter, detect, record, report and remedy fraud in insurance.

b. Legislation addresses insurer fraud.

c. Claims fraud is a punishable offence.

d. The supervisory authority requires insurers and intermediaries to ensure high standards of integrity of their business.

e. The supervisory authority requires that insurers and intermediaries allocate appropriate resources and implement effective procedures and controls to deter, detect, record and, as required, promptly report fraud to appropriate authorities. This function is under the responsibility of senior staff of the insurer and intermediary.

f. As required, the supervisory authority ascertains that insurers take effective measures to prevent fraud, including providing counter-fraud training to management and staff. The supervisory authority promotes the exchange of information between insurers with respect to fraud and those committing fraud including, as appropriate, through the use of databases.

g. The supervisory authority co-operates with other supervisory authorities including, as appropriate, in other jurisdictions in countering fraud.

8. Anti-money laundering, combating the financing of terrorism

ICP 28	**Anti-money laundering, combating the financing of terrorism (AML/CFT)**
	The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).

Explanatory note

28.1. In most IAIS member jurisdictions, money laundering and financing of terrorism are criminal acts under the law. Money laundering is the processing of criminal proceeds to disguise their illegal origin. The financing of terrorism involves the direct or indirect provision of funds, whether lawfully or unlawfully obtained, for terrorist acts or to terrorist organisations.

28.2. Insurers and intermediaries, in particular those insurers and intermediaries offering life insurance or other investment related insurance could be involved, knowingly or unknowingly, in money laundering and financing of terrorism. This exposes them to legal, operational and reputational risks. Supervisory authorities, in conjunction with law enforcement authorities and in co-operation with other supervisors, must adequately supervise insurers and intermediaries for AML/CFT purposes to prevent and counter such activities.

Essential criteria

a. The measures required under the AML/CFT legislation and the activities of the supervisors should meet the criteria under those FATF Recommendations applicable to the insurance sector.[5]

b. The supervisory authority has adequate powers of supervision, enforcement and sanction in order to monitor and ensure compliance with AML/CFT requirements. Furthermore, the supervisory authority has the authority to take the necessary supervisory measures to prevent criminals or their associates from holding or being the beneficial owner of a significant or controlling interest or holding a management function in an insurer or an intermediary.

c. The supervisory authority has appropriate authority to co-operate effectively with the domestic Financial Intelligence Unit (FIU) and domestic enforcement authorities, as well as with other supervisors both domestic and foreign, for AML/CFT purposes.

d. The supervisory authority devotes adequate resources - financial, human and technical - to AML/CFT supervisory activities.

e. The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to comply with AML/CFT requirements, which are consistent with the FATF Recommendations applicable to the insurance sector, including:

[5] See FATF Recommendations 4-6, 8-11, 13-15,17,21-23, 25, 29-32 and 40 as well as Special Recommendations IV, V and the AML /CFT Methodology for a description of the complete set of AML/CFT measures that are required.

- performing the necessary customer due diligence (CDD) on customers, beneficial owners and beneficiaries
- taking enhanced measures with respect to higher risk customers
- maintaining full business and transaction records, including CDD data, for at least 5 years
- monitoring for complex, unusual large transactions, or unusual patterns of transactions, that have no apparent or visible economic or lawful purpose
- reporting suspicious transactions to the FIU
- developing internal programmes (including training), procedures, controls and audit functions to combat money laundering and terrorist financing
- ensuring that their foreign branches and subsidiaries observe appropriate AML/CFT measures consistent with the home jurisdiction requirements.

Annex 1 - References[6]

Conditions for effective supervision

ICP 1	Conditions for effective insurance supervision

The supervisory system

ICP 2	Supervisory objectives
ICP 3	Supervisory authority
ICP 4	Supervisory process
ICP 5	Supervisory cooperation and information sharing

References:

- Principles No. 2. Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Business Operations *(Approved December 1999)*
- Principles No. 6. Principles on Minimum Requirements for Supervision of Reinsurers *(Approved October 2002)*
- Supervisory Standard No. 6. Supervisory Standard on the Exchange of Information *(Approved January 2002)*
- Supervisory Standard No. 8. Standard on supervision of reinsurers *(Approved October 2003)*
- Guidance Paper No. 2. A Model Memorandum of Understanding (to facilitate the exchange of information between financial supervisors) *(Approved September 1997)*
- IMF's Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles *(September 1999 and July 2000)*

The supervised entity

ICP 6	Licensing
ICP 7	Suitability of persons
ICP 8	Changes in control and portfolio transfers
ICP 9	Corporate governance
ICP 10	Internal control

References:

- Principles No. 2. Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Business Operations *(Approved December 1999)*
- Principles No. 6. Principles on Minimum Requirements for Supervision of Reinsurers *(Approved October 2002)*
- Supervisory Standard No. 1. Supervisory Standard on Licensing *(Approved October 1998)*
- Supervisory Standard No.3. Supervisory Standard on Derivatives *(Approved October 1998)*
- Supervisory Standard No.4. Supervisory Standard on Asset Management by Insurance Companies *(Approved December 1999)*
- Supervisory Standard No.7. Supervisory Standard on the Evaluation of the Reinsurance Cover *(Approved January 2002)*
- Supervisory Standard No. 8. Standard on supervision of reinsurers *(Approved October 2003)*
- Guidance Paper No 1. Guidance on Insurance Regulation and Supervision for Emerging Market Economies *(Approved September 1997)*

[6] Note: papers that are still in draft but whose adoption is anticipated at the October 2003 General Meeting are listed in bold. Annual updating of this part of the document will be necessary.

- Guidance Paper No. 2. A Model Memorandum of Understanding (to facilitate the exchange of information between financial supervisors) *(Approved September 1997)*
- Guidance Paper No. 3. Guidance Paper for Fit And Proper Principles and their Application *(Approved October 2000)*
- Guidance Paper No. 7: The Use of actuaries as part of a supervisory model *(Approved October 2003)*

On-going Supervision

ICP 11	Market analysis
ICP 12	Reporting to supervisors and off-site monitoring
ICP 13	On-site inspection
ICP 14	Preventive and corrective measures
ICP 15	Enforcement or sanctions
ICP 16	Winding-up & exit from the market
ICP 17	Group-wide supervision

References:

- Principles No. 6. Principles on Minimum Requirements for Supervision of Reinsurers *(Approved October 2002)*
- Supervisory Standard No. 2. Supervisory Standard on On-Site Inspections *(Approved October 1998)*
- Supervisory Standard No. 5. Supervisory Standard on Group Coordination *(Approved October 2000)*
- Supervisory Standard No. 7. Supervisory Standard on the Evaluation of the Reinsurance Cover *(Approved January 2002)*
- Guidance Paper No. 6: Solvency control levels *(Approved October 2003)*
- Joint Forum papers pertaining to:
  - coordination
  - supervisory information sharing
  - capital adequacy
  - fit and proper tests
  - intra-group transactions and exposures
  - risk concentrations

Prudential requirements

ICP 18	Risk assessment and management
ICP 19	Insurance activity
ICP 20	Liabilities
ICP 21	Investments
ICP 22	Derivatives and similar commitments
ICP 23	Capital adequacy and solvency

References:

- Principles No. 5. Principles on Capital Adequacy and Solvency *(Approved January 2002)*
- Principles No. 6. Principles on Minimum Requirements for Supervision of Reinsurers *(Approved October 2002)*
- Supervisory Standard No. 3. Supervisory Standard on Derivatives *(Approved October 1998)*
- Supervisory Standard No. 4. Supervisory Standard on Asset Management by Insurance Companies *(Approved December 1999)*

- Supervisory Standard No. 7. Supervisory Standard on the Evaluation of the Reinsurance Cover *(Approved January 2002)*
- Supervisory Standard No. 8. Standard on supervision of reinsurers *(Approved October 2003)*
- Guidance Paper No. 7: The Use of actuaries as part of a supervisory model *(Approved October 2003)*
- Guidance Paper No. 6: Solvency control levels *(Approved October 2003)*
- Guidance Paper No. 8: Stress testing *(Approved October 2003)*
- Discussion Paper Quantifying and Assessing Insurance Liabilities - January 2003

Markets and consumers

ICP 24	Intermediaries
ICP 25	Consumer protection
ICP 26	Information, disclosure & transparency towards the market
ICP 27	Fraud

References:
- Principles No. 3. Principles for the Conduct of Insurance Business *(Approved December 1999)*
- Principles No. 4. Principles on the Supervision of Insurance Activities on the Internet *(Approved October 2000)*
- Guidance Paper No. 4. Guidance Paper on Public Disclosure by Insurers *(Approved January 2002)*

Anti-money laundering/ Combating the Financing of Terrorism

ICP 28	Anti-money laundering/ Combating the Financing of Terrorism

References:
- Guidance Paper No. 5. Anti-Money Laundering Guidance Notes for Insurance Supervisors and Insurance Entities *(Approved January 2002)*
- Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism Standards *(prepared IMF, World Bank, Financial Action Task Force and approved by at an FATF plenary meeting October 2002)*

Annex 2 - Assessment methodology

1. This annex sets out factors that should be considered when carrying out an assessment of a jurisdiction or authority's observance of the *Insurance core principles* and criteria.

2. The IAIS strongly encourages implementation of the framework for effective supervision described by the *Insurance core principles*. Assessments can facilitate implementation by identifying the extent and nature of any weaknesses in a jurisdiction's supervisory framework -- especially those aspects that could affect policyholder protection and market stability -- as well as recommending possible remedies.

3. The framework described by the *Insurance core principles* is general. Supervisors have flexibility in adapting it to the domestic context (e.g., depending on the market structure and stage of development). The explanatory notes and criteria provide more guidance on what is expected in order to implement each principle. They also facilitate assessments that are comprehensive, precise and consistent. While the results of the assessments may not always be made public, it is still important for their credibility that they are conducted in a broadly uniform manner from jurisdiction to jurisdiction.

Scope

4. Assessments against the *Insurance core principles* can be conducted in a number of contexts including:

- self assessments performed by insurance supervisors themselves, sometimes with the assistance of other experts
- reviews conducted by third parties and, in particular, those conducted in the context of the IMF and World Bank Financial Sector Assessment Program (FSAP).

5. Assessments can be limited to the responsibilities of a particular insurance supervisory authority or relate to the jurisdiction as a whole. Whatever the case, this should be clearly understood by all parties concerned. FSAP reviews are always done with respect to the jurisdiction as a whole. Where more than one authority is involved in the supervisory process then the interaction of supervisory roles should be clearly described in the assessment.

Conduct of independent assessments - assessment by experts

6. The process of assessing each principle requires a judgmental weighing of numerous elements that only qualified assessors with practical and relevant experience can provide. Normally an independent assessment would be conducted by at least one expert. Assessors not familiar with the insurance sector, while possibly providing a fresh perspective, could come to incorrect or misleading conclusions due to their lack of sector specific knowledge.

Conduct of independent assessments - access to information

7. When conducting an independent assessment, prior consent from the relevant local authorities is required so that assessors can have access to a range of information and people. The required information may include not only published information such as the laws, regulations and administrative policies but also non-published information, such as self-assessments, operational guidelines for insurance supervisors, and the like. The information should be provided as long as it does not violate confidentiality requirements. The assessor will need to meet with various individuals and organisations, including the insurance supervisor or supervisors, other domestic supervisory authorities, any relevant government ministries, insurance companies and insurance industry associations, actuaries, auditors, and other financial sector participants.

Assessment categories

Assessment of essential criteria

8. In making the assessment, each of the **essential criteria** has to be considered. The criteria should be assessed using five categories: **observed, largely observed, partly observed, not observed,** and **not applicable**.

9. For a criterion to be considered **observed,** it is usually necessary that the authority has the legal authority to perform its tasks and that it exercises this authority to a satisfactory standard. Where the supervisory authority sets requirements it should also ensure that these requirements are implemented. Having the necessary resources is essential for the supervisory authority to effectively implement the requirements. Just to accept the power in the law is insufficient for full observance to be recorded against a criterion except where the criterion is specifically limited in this respect. In the event that the supervisor has a history of using a practice for which it has no explicit legal authority, the assessment may be considered as observed if the practice is clearly substantiated as common and undisputed.

10. Normally, but not always, the *Insurance core principles* should be equally applicable to both life and non-life sectors in order for an overall rating to be assigned. Similarly, it is possible that certain specialised parts of the insurance sector would have observance with the *Insurance core principles* differing from the other insurance business in the jurisdiction. Where the legal or practical position is materially different between life and non life insurance or with respect to specialised parts of the insurance business in the jurisdiction such that it would give rise to a different rating had the assessments been carried out separately, it is open to the assessor to consider assigning a level of observance separately for the two parts of the insurance sector for that particular principle. In such cases, the distinction should be clearly identified in the report.

11. Assessments are based solely on the laws, regulations and other supervisory requirements or practices that are in place at the time. Proposed improvements can be noted in the assessment report by way of additional comments so as to give credit for efforts that are important but at the time the assessment is made, have yet to be fully implemented. Similarly, laws that do not meet with a satisfactory level of observance in practice cannot be recorded as "observed". As a result, it is important to recognise when the assessment is conducted and to record this in the report.

12. For a criterion to be considered as **largely observed,** it is necessary that only minor shortcomings exist which do not raise any concerns about the authority's ability to achieve full observance with the criterion. A criterion will be considered **partly observed** whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority's ability to achieve observance. A criterion will be considered **not observed** whenever no substantive progress toward observance has been achieved.

13. A criterion would be considered **not applicable** whenever:

- the criterion does not apply given the structural, legal and institutional features of a jurisdiction[7]
- an assessment is conducted in the context of the individual supervisory authority and the criterion is the responsibility of other authorities in the jurisdiction (for example for ICP 1). In this instance, the relevant authority should be clearly identified in the assessment report.

14. In the assessment of ICP 1 the assessor may refer to recent assessments or studies on these matters by public international institutions where available.

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[7]. An example of this situation is if a jurisdiction prohibits the use of derivatives and similar commitments. In such a case, most, if not all, of the criteria under ICP 22 would be noted as not applicable.

Assessment of advanced criteria

15. With respect to the advanced criteria set forth in this document, these may or may not be assessed depending on the objectives and views of those sponsoring the exercise. Even when they are included, however, the results will not be a factor in coming to an overall view on observance with a principle. Instead, the assessment of the advanced criteria is recorded in the description and informs the comments and recommendations as appropriate. For consistency only essential criteria are taken into account in the assessment of the overall core principle.

Assessment of principles

16. As noted above, the level of observance for each principle reflects the assessments of the essential criteria. A principle will be considered **observed** whenever all the essential criteria are considered to be observed or when all the essential criteria are observed except for a number that are considered not applicable. A principle will be considered to be **not applicable** when the essential criteria are considered to be not applicable.

17. With respect to an assessment of the principle that is other than observed or not applicable, similar guidance is to be used as applies to the criteria themselves. So, for a principle to be considered **largely observed,** it is necessary that only minor shortcomings exist which do not raise any concerns about the authority's ability to achieve full observance with the principle. A principle will be considered **partly observed** whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority's ability to achieve observance. A principle will be considered **not observed** whenever no substantive progress toward observance has been achieved.

18. While it is generally expected that full observance of a principle would be achieved through the observance of the essential criteria, there may be instances, where a jurisdiction can demonstrate that observance with a principle has been achieved through different means. Conversely, due to specific conditions in a jurisdiction, meeting the essential criteria may not be sufficient to achieve observance of the objective of a principle. In these cases, additional measures are needed in order for observance of the particular principle to be considered effective.

Reporting

19. The IAIS does not prescribe the precise format or content of reports that result from an assessment against the *Insurance core principles*. It does, however, consider that the report should:

- be in writing
- include both the assessment of observance itself and any additional information referred to in this section
- identify the scope and timing of the assessment
- identify the assessors
- in the case of an external assessment, refer to the information reviewed and meetings conducted, and note when any of the necessary information was not provided and the impact that this may have had on the accuracy of the assessment
- in the case of an external assessment, include prioritised recommendations for achieving improved observance of the *Insurance core principles* recognising that the assessment should not be considered as an end in itself.
- in the case of an external assessment, include the formal comments provided by the authorities in response to the assessment.

20. The question of publication of the results of an assessment is a matter for the local authorities.

Principles No. 2

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

PRINCIPLES APPLICABLE TO THE SUPERVISION OF INTERNATIONAL INSURERS AND INSURANCE GROUPS AND THEIR CROSS-BORDER BUSINESS OPERATIONS

(Insurance Concordat)

December 1999

Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-border Business Operations

Contents

1. Introduction

1. The overall objective of insurance supervision is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. To achieve this objective in an environment where many insurers and insurance groups are rapidly extending their international operations, often into new and emerging markets, there is an increasing need for insurance supervisors to co-operate with each other. The purpose of this paper is therefore to develop practical standards that members may chose to apply, and in this sense to establish principles for co-operation between insurance supervisors in the supervision of the foreign[1] business operations of international insurers and insurance groups with a view to maintaining and enhancing its effectiveness. The main focus is on regulation in the interests of policyholders and potential policyholders of the financial strength of insurers and their ability to pay claims - and not on conduct of business regulation. The principles which are elaborated below should be implemented taking full account of any international obligations which may also be applicable.

2. This paper covers foreign branches (and the equivalent[2]), which are integral parts of an insurer incorporated in a different jurisdiction; foreign subsidiaries, which are legally separate

[1] a) In the United States, the term "foreign" is normally utilised by State supervisors to denote insurers with their head office in another US State. Insurers with a head office outside the United States are designated "alien" insurers. The principles developed in this paper will be applied in the United States taking account of this difference in terminology.
b) The principles will be applied within the European Union (EU) taking account of the provisions for mutual recognition, and the exercise of home jurisdiction control over branches in other EU Member States.

[2] References to branches elsewhere in the paper are to be taken to cover equivalent establishments.

institutions incorporated in a different jurisdiction from that of the parent insurers which have control over them; joint ventures, which are legally separate institutions owned and controlled by two or more parent institutions, at least one of which is incorporated in a different jurisdiction, and not all of which are necessarily insurers; and the cross-border provision of insurance on a services basis.

3. This paper does not consider questions arising from the provision of insurance over the Internet. Nor does it cover the activities of pure reinsurers, which are directly supervised in some jurisdictions but not in others, although this gap may be partly filled by the close interest most supervisors take in the quality of the reinsurance programmes placed by the direct insurers they supervise, or by the imposition of financial or other requirements on reinsurance contracts as a condition for credit being given for reinsurance ceded by direct insurers. These are two areas to which the IAIS will revert.

2. Definitions

4. The following definitions apply to terms used in the paper:

Home jurisdiction. A home jurisdiction is one in which a parent insurer is incorporated, or in which the head office of a branch is incorporated. Host jurisdictions/supervisors must be aware of the distinctions between immediate and higher level home jurisdictions/supervisors, taking account of the hierarchical corporate structures of many international insurers and insurance groups. Except where specified, the terms home jurisdiction/supervisor where they appear cover both immediate and higher levels.

Host jurisdiction. A host jurisdiction is one in which a branch of a foreign insurer is located; or in which a subsidiary or joint venture of a foreign parent insurer is incorporated; or, in the case of the cross-border provision of insurance on a services basis, the jurisdiction in which the service is provided.

Insurer/insurance company both in the text and other definitions refers to a licensed legal entity which underwrites insurance (but note the exemption of pure reinsurers).

Insurance group refers, in this paper, to a group structure which contains two or more insurers. The structure of international insurance groups may derive from an ultimate holding company which 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).

Jurisdiction refers to a country, state, province, or other jurisdiction with legally enforceable local insurance laws that relate to the incorporation or operation of insurance companies.

Licensing refers, in this paper, to the incorporation of an insurer in the jurisdiction or the approval given to a company to underwrite insurance in the jurisdiction. These are recognised to be separate

approvals and may be made in separate jurisdictions. The principles which apply to licensing apply to both types of approval.

Solo supervision. There is no unique, comprehensive definition of "solo supervision". For the purposes of this paper solo supervision refers to supervision of an insurer by the supervisor in the jurisdiction where the insurer is incorporated: this is bound to cover the whole company, but the focus may be on the protection of all policyholders of the company, or only those in the jurisdiction of the supervisor in question. Under solo supervision there can be no automatic assumption that the entity in question will receive additional financial support from a parent institution, or that it - in turn - will have moral or commercial obligations to support other insurers in which it has invested beyond the extent of those investments, or other contractual obligations (for example guarantees). The concept of solo supervision in the context of this paper is not in any way intended to exclude the possibility of supervision of a branch by a host jurisdiction.

Supervisor refers, as appropriate, to either the insurance regulator or the insurance supervisor in the jurisdiction.

3. Principles for the supervision of cross-border business operations

5. The following principles for the supervision of cross-border business operations are proposed for application by individual supervisors.

Principle 1: No foreign insurance establishments should escape supervision

6. A primary aim of co-operation between insurance supervisors is to ensure that no insurance establishment escapes supervision. Whilst being sensitive to the potential for unnecessary duplication of supervision, each supervisor has a duty to ensure that all foreign insurance establishments in its jurisdiction are effectively supervised. Acceptance of this principle does not remove the possibility of gaps in supervision. Gaps may occur, for example, when an establishment is classified as an insurer by the home supervisor but not by the host supervisor, or vice versa.

7. There are differences in the supervision of subsidiaries and branches. Subsidiaries should always be supervised in the host jurisdiction where they are incorporated, and will be subject to host rules on capital adequacy/solvency. Branches will also usually come under host jurisdiction supervision (except where mutual recognition schemes operate as in the EU). However, branch solvency may be assessed under the provisions applying in both home and host jurisdictions. In some cases the branch's host supervisor may be willing to rely on the home supervisor's assessment.

Principle 2: All insurance establishments of international insurance groups and international insurers should be subject to effective supervision.

8. In deciding whether, and if so on what basis, to license or to continue a licence of a subsidiary or branch of a foreign insurer in its jurisdiction, the host supervisor may need to assess on a case by case basis the effectiveness of the supervision of the foreign insurer in its home jurisdiction, consulting the home supervisor as necessary. This assessment would take into account IAIS general supervisory principles and standards and the ability of the home supervisor to apply sanctions to prevent corporate structures that conflict with effective supervision.

9. The traditional approach to insurance supervision has laid the primary emphasis on effective solo supervision of individual insurance companies. Because insurance companies are less vulnerable to risks of contagion than, for example banks, and because they are more rarely a source of systemic risk to the wider financial system, insurance supervisors seek to ring fence an individual insurer incorporated in their jurisdiction, isolating it from other companies in the same group.

10. Where, however, a parent insurer has material participations in other insurers (or in other financial institutions), it is important to take into account the potential additional risks created by the existence of a group in assessing the financial strength of the parent insurer and the group as a whole: notably the possible effects of double gearing of capital on solvency; intra-group transactions, and large exposures. Work on the prudent treatment of such situations is going on in other fora, and will need in due course to be incorporated into a "solo-plus" or group-wide view of the supervision of international insurance groups. This will not, however, diminish the importance of the effective supervision of international insurers on a solo basis.

Principle 3: The creation of a cross-border insurance establishment should be subject to consultation between the host and home supervisors

11. The initial opportunity for collaboration between host and home supervisors occurs when an individual application by an insurer to establish a new foreign presence is first made. The licensing procedure also offers a good opportunity for host and home authorities to create the basis for future collaboration.

12. Host supervisors may wish to consult home supervisors on particular aspects of an licensing proposal, but in any event they should always consider checking that the home supervisor of the immediate insurance parent has no objection before granting a licence. This process might give an opportunity to a home supervisor which disapproves of its insurer's plans to establish abroad to make its reasons known to the host supervisor, and perhaps recommend that the host supervisor refuse a licence. Where such checks are made and where a host supervisor is unable to obtain a positive reply from a home supervisor with the legal authority to respond, or a qualified response is received, it should consider either refusing the application, increasing the intensity of supervision or

imposing conditions on the grant of a licence. The host supervisor should inform the home supervisor of any restrictions or prohibitions imposed on a licence.

13. Host supervisors should exercise particular caution in approving applications for a licence from foreign entities which are not subject to prudential regulation of their capital strength in the home jurisdiction, or joint ventures for which there is no clear parental responsibility. In such circumstances, any licence should be contingent on the host supervisor's capacity to impose specific restrictions on activities - or require specific guarantees - and supervise the company effectively.

14. The final decision on licensing should remain with the host supervisor on the basis of non-discriminatory criteria (except where a mutual recognition scheme operates as in the EU). Home supervisors should maintain a listing of all the cross-border establishments of their insurers.

Principle 4: Foreign insurers providing insurance cover on a cross-border services basis should be subject to effective supervision

15. Whether or not foreign insurers are permitted to provide insurance services on a cross-border basis in any jurisdiction is usually a matter of law in the jurisdiction concerned.

16. Where consumers have the unrestricted freedom to seek insurance abroad on their own initiative, the presumption is normally that they take responsibility for their own actions. However, where the active promotion of insurance contracts on a cross-border services basis is permitted, the host supervisor may wish to be notified of the intention of a foreign insurer to promote insurance contracts within their jurisdiction, and to check that the foreign insurer is subject to prudential regulation of their capital strength in the home jurisdiction.[3] Another legitimate approach might be the application of a special licensing procedure, or the introduction of specific safeguards to protect the policyholder.

17. If the active promotion of insurance contracts on a cross-border services basis is permitted, the home supervisor will retain the primary responsibility for ensuring that the insurer remains solvent, the host supervisor should consider very seriously any reservations or objections expressed by the home supervisor to the insurer's proposed activity. Home supervisors should have the power to prevent insurers within their jurisdiction from promoting contracts of insurance on a cross-border basis in foreign jurisdictions if they consider that the insurer does not have the required financial capacity, or the necessary expertise to manage this business prudently.

18. Where the host supervisor has been notified of the intention of a foreign insurer to promote insurance contracts within their jurisdiction, the host supervisor should consider what information should be made available to the consumer by the foreign insurer. This might include details of the authority responsible for the supervision of the insurer.

[3] Particular care should be taken where it is proposed that cross-border services be provided through a branch of the foreign insurer located in a jurisdiction other than the home jurisdiction . In such cases both the home supervisor and the supervisor of the branch should be aware of the business being conducted.

4. Aids to cooperation

19. Mutual trust between supervisors is enhanced if information can flow with confidence in both directions on a broadly reciprocal basis. In seeking to improve the supervision of international insurers and insurance groups, efforts continue to be required to improve information exchange between insurers and supervisors, and between different supervisors. The purpose is to address material supervisory issues, not simply to circulate large amounts of routine information. The need to exchange information encompasses the following elements.

4.1 Information needs of home supervisors

20. The principal requirement of the home supervisor is to ensure that its information needs from the parent insurer are fully met in a timely fashion. This will typically require a sound and verifiable system of reporting from any foreign establishment to the head office or parent insurer,[4] and that practical solutions be found for dealing with particular information needs. To this end:

a. Home supervisors should seek to satisfy themselves that insurers' internal controls include comprehensive and regular reporting between an insurer's foreign establishments and its head office, so that the overall financial situation of the insurer and the effectiveness of its control systems can be accurately reported and assessed.

b. If a host supervisor identifies, or has reason to suspect, problems of a material nature in a foreign establishment, it should take the initiative to inform the home supervisor, subject to its own judgement. The level of materiality will vary according to the nature of the problem. Home supervisors may wish to inform host supervisors as to the precise levels of materiality which would trigger their concern. However, the host supervisor is often in the best position to detect problems and therefore should be ready to act on its own initiative.

c. Home supervisors may wish to seek an independent check on data reported by an individual foreign establishment. Where inspection by home supervisors is permitted, host supervisors should welcome such inspections. Where inspection by home supervisors is not at present possible (or where the home supervisor does not use the inspection process), the home supervisor can consult the host supervisor with a view to the host supervisor checking or commenting on designated features of the insurer's activities. It is desirable that the results obtained should be available to both host and home supervisor.

d. If serious problems arise in a foreign establishment, the host supervisor may wish to consult with the head office or parent insurer and also with the home supervisor in order to design possible remedies. Where such consultation with the home supervisor has taken place, and the host supervisor decides to withdraw the licence of a foreign establishment or take similar action, the home supervisor should, where possible and appropriate, be given prior warning.

[4] The home supervisor should ensure that full information is available in the case of outsourced functions.

e. In some instances the host supervisor may, by agreement with the home supervisor, share responsibility for and co-ordinate supervisory activities with the home supervisor.

21. Host supervisors should make the home supervisor aware of any material difficulties arising from the provision of insurance on a cross-border services basis.

4.2 Information needs of host supervisors

22. Host supervision of foreign establishments will be more effective if it is undertaken with an awareness of the extent to which the home supervisor of the immediate parent insurer monitors the foreign establishment and of any prudential constraints placed on the parent insurer or the group as a whole. To this end:

a. Home supervisors should inform host supervisors of changes in supervisory measures which have a significant bearing on the operations of their insurers' foreign establishments, subject to their own judgement. Home supervisors should respond positively to approaches from host supervisors for factual information covering, for example, the scope of the activities of a local establishment, its role within the insurance group and the application of internal controls and for information relevant for effective supervision by host supervisors.

b. Where a home supervisor has doubts about the standard of host supervision in a particular jurisdiction and, as a consequence, is envisaging action which will affect foreign establishments in the jurisdiction concerned, the home supervisor should consult the host supervisor in advance.

c. In the case of particular insurers, home supervisors should be ready to take host supervisors into their confidence as much as possible. Even in sensitive cases such as impending changes of ownership or when an insurer faces problems, liaison between home and host supervisors may be mutually advantageous, though decisions on both substance and timing on such sensitive issues can only be taken case by case.

23. Home supervisors should respond positively to approaches from host supervisors seeking factual information on individual insurers known to be providing insurance on a cross-border services basis.

4.3 Confidentiality constraints on the flow of information

24. The freedom to exchange prudential information, subject to certain conditions designed to protect both the provider and receiver of the information, greatly enhances effective collaboration between supervisors. A possible obstacle to the transmission of prudential information is the different level of confidentiality regulations in different jurisdictions.

25. Jurisdictions whose confidentiality requirements continue to constrain or prevent the sharing of information for supervisory purposes with insurance supervisors in other jurisdictions, and the

countries where information received from a foreign supervisor cannot be kept confidential, are urged to review their requirements in consideration of the following conditions:

a. Information received should only be used for purposes related the supervision of financial institutions.

b. Information sharing arrangements should allow for a two-way flow of information, but strict reciprocity in respect of the format and detailed characteristics of the information should not be demanded.

c. The confidentiality of information transmitted should be legally protected, except in the event of criminal prosecution.[5] All insurance supervisors should, of course, be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections.

d. The recipient should undertake, where possible, to consult with the supervisor providing the information if he proposes to take action on the evidence of the information received.

26. Supervisors may wish to consider, on a case by case basis, and consulting each other as necessary, the appropriateness of informing the companies on which they have exchanged information of the nature of the contact made.

5. External audit

27. Supervisors can gain reassurance from sound international auditing and actuarial standards. At present, not all foreign establishments are subject to external audit and, even where they are, the audit work may not be sufficiently thorough. All foreign establishments should be subject to external audit, where necessary either at the instigation of the home or host supervisor.

28. The existence of adequate provision for external audit is an important consideration for insurance supervisors, and might be a factor taken into account in deciding on licences for new establishments. For the foreign establishments of international insurers and insurance groups the audit firm may often be the one that audits the parent insurer, provided the firm in question has the appropriate capacity and experience in the host jurisdiction. Where a foreign establishment is audited by a different firm, it is desirable that the external auditor and the insurance supervisor of the parent insurer satisfy themselves as to the proper audit of the foreign establishment.

29. Supervisors have a strong interest in the quality and thoroughness of audits. Where audits are inadequately conducted, supervisors should address criticism to the local representative body of auditors. It is desirable that the insurance supervisor be empowered, where necessary, to insist on a further audit by a different auditor or to have the auditor replaced. As a means of raising auditing

[5] Supervisors may also be subpoenaed to give evidence in civil cases. Although in some jurisdictions they may be open to contempt of court if they refuse, they can make clear that, if the court insists, the information flow would dry up and their own ability to supervise effectively in future would be impaired.

standards for international insurance groups, it is desirable that auditors with recognised experience of insurance audit, including within the jurisdiction concerned, be appointed. Where any doubt arises, host and home supervisors should consider consulting.

30. External auditors may also be asked to verify the accuracy of reporting returns or compliance with any special conditions. It is desirable that all supervisors should have the ability to communicate with insurance external auditors and vice versa. Effective co-ordination between insurance supervisors and external auditors is encouraged. However, whilst external auditors can play a key role, their involvement does not reduce in any way the need for sound internal controls, including provision for effective internal audit.

Principles No. 3

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

PRINCIPLES FOR THE CONDUCT OF INSURANCE BUSINESS

December 1999

Principles for the Conduct of Insurance Business

Table of Contents

Definitions:

In this paper:

Insurer/Insurance company refers to a licensed legal entity which underwrites insurance.

Insurance supervisory authority refers, as appropriate, to either the insurance regulatory authority or the insurance supervisory authority in the jurisdiction.

Jurisdiction refers to a country, state, province or other territory with legally enforceable local insurance laws which relate to the incorporation or operation of insurers and/or intermediaries.

Intermediary refers to any person who, or organisation which, gives advice by way of direct offering advertising or on a person-to-person basis in respect of an insurance product and includes the promotion of such product or the facilitation of an agreement or contract between an insurer and a customer. Intermediaries are generally divided into separate classes. The most common types are 'Independent intermediaries' who represent the buyer in dealings with the insurer (also known as independent brokers) and 'agents' (which generally include multiple agents and sub-agents) who represent the insurer;

Service provider refers to an insurer and/or intermediary, read in the context of its usage.

Customer implies policyholder and potential policyholder.

I. Background

1. The principal task of all insurance supervisory authorities is to establish a means of ensuring high standards of financial soundness and conduct of all insurers under their supervision. The main objectives of such measurers are to provide a high degree of security to the policyholders and to maintain the confidence in the industry.

2. For a large number of market participants insurance products are difficult to understand and evaluate. They take the form of contractually agreed promises by the insurer to provide benefits or compensation (indemnity) to cover specified events or risks in exchange for certain obligations by the policyholder. As a result it is important for customers to have relevant, meaningful and understandable information, as far as possible in writing. Written information may be supplemented by verbal information. Accordingly persons providing verbal information must possess the necessary knowledge to give advice.

3. Arrangements must therefore exist for potential policyholders to have access to all material information before the conclusion of an insurance contract, to receive advice in a correct and meaningful manner in assessing their insurance requirements, to be informed about their rights and obligations for the duration of the contract, to be confident that they will receive correct and timely compensation in the event of a legitimate claim and in case of doubt to be able to receive supplementary advice from a neutral body. Policyholders have a right to deal with honest, trustworthy and knowledgeable insurers and intermediaries.

4. Insurers and intermediaries have a greater knowledge of insurance issues than the majority of policyholders. Consumers may not be able to detect contracts which could be biased in favour of insurers, which may be unreasonably interpreted to favour the insurer or which simply fail to meet their needs. Marketing methods could place potential policyholders under pressure. There could be other anti-consumer practices that support the need for sound market conduct principles. It is for these reasons that conduct of business principles, approved by regulators, should be in place.

5. ***Principles*** for the conduct of insurance business can be expected to improve insurer, intermediary and consumer relationships and thereby strengthen consumer confidence and protection. A set of common *principles* should provide basic standards of business conduct, wherever business is undertaken. This should facilitate cross border business, encourage competition and protect the integrity of the market. Such a framework of *principles* will provide guidance as to what are legitimate and acceptable market practices. It will set the background to test types of behaviour that may lead to enforce action (if applicable) and provide guidance for setting local rules so that those adversely affected by market abuse have a facility to seek appropriate redress.

6. The tasks of domestic regulators will be made easier if international principles can be agreed upon. This implies that each jurisdiction should decide on the legislative status, implementation and accountability regarding these *principles*. Clear responsibilities should be established for monitoring, enforcing and instituting sanctions, where necessary. These principles could be developed further by setting standards which could then be adapted by

domestic regulators to fit their own circumstances. These standards will be the subject of separate papers.

7. The *principles* are intended to apply to insurers and intermediaries involved in all aspects of insurance. The issues are described in terms of the implications of these *principles* in the retail insurance market place. This approach is not intended to preclude the application of the *principles* to the wholesale, employee benefit and reinsurance markets.

8. These *principles* for the conduct of insurance business are applicable to the conduct of both insurers and intermediaries, whether they are individuals or legal entities. Specific *principles* may be applicable to only one or either of them. However, adherence to these Principles by insurers and/or intermediaries does not mean consumers should not take the utmost care in assessing the risks and the suitability of the product to their needs.

II. Principles for the Conduct of Insurance Business

Insurance supervisors should therefore ensure that the following *principles* be adhered to in the best interests of the customers and the integrity of the market.

Principle 1: Integrity

Insurers and intermediaries should at all times act honestly and in a straightforward manner.

9. Service providers have an obligation to avoid misleading and deceptive acts or representations. Service providers should not seek to exclude or restrict any duty or liability to a customer which it has under a legislative framework and/or accepted practices. It should also not seek to unreasonably rely on any provision seeking to exclude or restrict any such duty or liability.

Principle 2: Skill, Care and Diligence

In conducting their business activities, insurers and intermediaries should act with due skill, care and diligence.

10. The service provider has a duty to act competently and diligently with regard to all transactions between itself and the customer. Where appropriate an assessment of the customer's individual requirements should be made to determine what insurance coverage is necessary. The concept of 'care' implies that insurers and intermediaries should discharge those duties as can reasonably be expected from a prudent person in a like position and under similar circumstances. It also includes arranging adequate protection for a customer's assets when responsible for them in the context of the nature of the service provider's legal structure and the business it undertakes.

Principle 3: Prudence

Insurers and intermediaries should conduct their business and organise their affairs with prudence.

11.1 This includes:

- maintaining adequate financial resources, including adequate liquidity, and
- maintaining effective risk management systems.

11.2 Prudence requires the insurer not to assume risks without taking due account of the possible consequences. 'Adequate' implies the taking into account of the necessary margins for unexpected contingencies. The possible impact of the insurer's non-regulated activities on its regulated activities should also be taken into account.

Principle 4: Disclosure of Information to Customers

Insurers and intermediaries should pay due regard to the information needs of their customers and treat them fairly.

12.1 This includes communicating:

- relevant and meaningful information in a timely and comprehensive manner to enable the customer to make a balanced and informed decision;
- the benefits and any risks to the customer in a fair and balanced way;
- the obligations of both the service provider and the customer in a clear and understandable way.

12.2 The service provider should take reasonable care that the information is accurate in all material respects, not misleading, easily understandable and available in writing or appropriate electronic means.

12.3 The customer should be given information about:

- the intermediary (if applicable) and especially its status i.e. whether the intermediary is independent or tied, e.g. whether the intermediary acts for the customer or the insurer;
- the insurer;
- the product e.g. price, cover, conditions, aims of product, risk factors, guarantees, special exclusions, et cetera;
- charges and estimated returns (if applicable); and

- complaints handling and other contractual arrangements;

12.4 The frequency with which information is to be disclosed should depend on the type of contractual arrangement.

Principle 5: Information about Customers

Insurers and intermediaries should seek from their customers information which might reasonably be expected before giving advice or concluding a contract.

13. The relationship between the service provider and customer should be one of trust. To build such a relationship the service provider should obtain sufficient information about the customer to assess its insurance needs. Information which a customer expects to be confidential should be treated as such. Customers should be informed about their duty to disclose relevant information.

Principle 6: Conflicts of Interest

Insurers and intermediaries should avoid conflicts of interest.

14. A service provider should avoid conflicts of interest. However where conflicts arise, the service provider should ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act, or otherwise. A service provider should not unfairly place its interests above those of its customers and where a properly informed customer would reasonably expect that the service provider would place the customer's interests above its own, the service provider should live up to that expectation.

Principle 7: Relationship with Regulators

Insurers and intermediaries should deal with their regulators in an open and cooperative way.

15. The service provider should deal with its regulator/supervisor in an open and cooperative manner and keep the regulator/supervisor promptly informed of significant events.

This principle extends to information and notification of events concerning non-regulated activities where appropriate. Service providers must ensure that an effective compliance programme is in place that meets the regulator/supervisor's requirements.

Principle 8: Complaints

Insurers and intermediaries should support a system of complaints handling where applicable.

Service providers should deal with complaints of customers effectively and fairly. A simple and equitable process of dispute resolution should be available through which complaints of customers can effectively be dealt with. This process should be well disclosed and easily accessible. It is advisable that, in addition, a neutral body, independent of the service providers, be set up as an alternative dispute resolution mechanism to deal with such complaints in an effective and affordable manner. Such neutral body should report publicly, at least annually and service providers should voluntarily support such a system.

Principle 9: Management and Control

Insurers and intermediaries should organise and control their affairs effectively.

17.1 A service provider should keep effective control over its own affairs. The management and control systems required will vary depending on the size and complexity of the service provider. Relatively simple procedures will be enough in the case of a one-person business, while sophisticated systems of control are likely to be necessary in the case of a complex organisation.

17.2 The service provider should, where appropriate:

17.2.1 have directors and senior managers who are and remain fit and proper for their roles;

17.2.2 apportion responsibilities among its directors and senior managers in such a way that:

- their individual responsibilities are clear; and
- the business of the service provider is adequately monitored through systems of internal control at senior management and board level;

17.2.3 operate robust arrangements for meeting the standards and requirements of the regulatory system, and for guarding against involvement in market abuse or financial crime (including the detection and prevention of money laundering); and

17.2.4 keep adequate and orderly records of its business and internal organisation.

17.3 Paragraph 17.2.1 deals with the service provider's responsibility to make sure its people are suitable for the roles they fill. This extends to competence as well as honesty, and in some cases their financial position may also be relevant. Persons who carry out functions on behalf of the service provider include not only employees, but also all kinds of intermediaries, corporate agents and providers of out sourced services.

17.4 Paragraph 17.2.2 requires the service provider to operate a clear division of duties among its directors and senior managers and to make sure that the whole business of the service provider are controlled at senior management level through an appropriate combination of individual and collective responsibilities.

17.5 Paragraph 17.2.3 requires the service provider to operate compliance arrangements that are robust and reliable. They must include safeguards against participating in or being used by others as a vehicle for market abuse or financial crimes such as money-laundering.

17.6 Paragraph 17.2.4 requires good records of business transacted which includes, whether audited or not, accounting statements, financial returns and/or statutory reports, including the balance sheet and income statement prepared for disclosure to the public and/or the insurance supervisory authorities. Good records also contain descriptions of the internal organisation - for example, of the apportionment and responsibilities among senior managers.

III. General

18. The above *principles* will form the base for specific standards of market conduct. These standards may have statutory backing or be supervised and enforced by industry associations, depending on what individual jurisdictions decide. They may contain some prescriptive measures and options from which supervisors may choose, - they may define best practice.

Principles No. 4

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

PRINCIPLES ON THE SUPERVISION OF INSURANCE ACTIVITIES ON THE INTERNET

OCTOBER 2004

This document was prepared by the Working Group on Electronic Commerce/Internet in consultation with members and observers.

This replaces the *Principles on the supervision of insurance activities on the internet* (October 2000)

Principles on the supervision of insurance activities on the internet

Contents

1. Introduction

1. The development of electronic commerce, particularly on the Internet, presents insurance supervisors and regulators, as well as insurers and insurance intermediaries, with new kinds of opportunities, challenges and questions. The use of the Internet will undoubtedly affect the ways in which insurance companies, intermediaries and insurance supervisors function in the future. For example, the number of cross border insurance transactions will increase.

2. In principle, there are considerable benefits for insurers, intermediaries and consumers alike from the development of the Internet. The use of information networks has the potential to make the offering of insurance products more efficient and less costly than before. Insurance companies and intermediaries are provided with the technical capability to reach many millions of potential policyholders with good quality information on their products and services. Consumers increasingly have access to more and more sophisticated programmes for searching for, identifying and purchasing insurance products.

3. However, whilst the Internet creates a new environment in which insurance products can be advertised, sold and delivered, it does not alter the fundamental principles of insurance, insurance intermediation and insurance supervision. It is a new medium through which to transact business.

4. Current concerns over the security of concluding contracts over the Internet are being addressed, but there remain substantial risks to consumers. Sales over the Internet extend the opportunities for insurance fraud, money laundering and mis-selling of insurance products. It presents insurance supervisors with new challenges in delivering the level of protection that consumers in their jurisdiction expect. In particular, it raises questions for consumers and insurance supervisors alike over the applicable contract law, and means of redress where there is a dispute between the insurer and insured. Unless consumers are confident that these issues

are adequately addressed the full potential of the Internet as a channel for distributing insurance products may not be realised.

5. One of the most important tasks of insurance supervision is the protection of policyholders and potential policyholders through the maintenance of efficient, fair, safe and stable insurance markets. The Internet does not change this basic premise. Where it helps is in offering insurance supervisors a new kind of medium for cooperation.

6. This paper proposes an environment for the supervision of insurance activities on the Internet which aims at ensuring that relevant information is available to consumers, insurers, intermediaries and insurance supervisors. Due to the extremely fast development of electronic commerce, the framework for the supervision of insurance activities on the Internet needs to be regularly reviewed.

2. Supervision and risk management of insurance activities on the Internet

7. Insurance supervisors should require that the sale, purchase, and delivery of insurance products over the Internet are conducted in a secure environment, and that policyholders are adequately protected. The primary responsibility for the supervision of insurance activities rests with the supervisor in the jurisdiction in which the insurer (or intermediary) is established and from which it conducts its Internet activities. The *IAIS Insurance Core Principles and Methodology* (October 2003) and the principles listed in this paper should be applied for the supervision of insurance activities on the Internet.[1]

8. Insurers, in particular, should give close consideration to the risks involved in electronic commerce. It is the overall responsibility of the board of directors and senior management to evaluate risks and produce a risk management plan for the insurance company. The management should incorporate changes in the insurer's operating environment.

9. Insurers and insurance intermediaries should closely examine and maintain control mechanisms to manage identified risks arising from insurance activities on the Internet.[2] In the context of the Internet, the key non-technical and operational risks to be considered include:

- strategic risks which arise when a company engages in a new business strategy; this does not consider all the implications that electronic commerce will have on other parts of the organisation or the insurer as a whole
- operational risks that arise as a result of a failure or default in the information technology infrastructure
- transaction risks such as risks of any unauthorised alterations or modifications to texts, information or data transmitted over computer networks between an insurer and its client, or vice versa. This may also include difficulties surrounding the collection of premiums.

1 Where the regulation of certain insurance activities on the Internet is the responsibility of another regulatory body, the supervisor should cooperate with that regulatory body to ensure that policyholders' interests are protected.

2 For further information, refer to the IAIS issues paper R*isks to insurers posed by electronic commerce* (October 2002).

- data security risks are considered to be the risks of losses, unintentional changes or leaks of information or data in computer systems
- connectivity risks, which are the risks that a failure in one part of the system may impact all or other parts of the system
- conduct of business risks, which relate to the fact that insurance laws and regulations have been developed with the view that business will be conducted on a person to person basis, with paper documentation. Electronic commerce poses many new issues with attendant risks in this respect.

In addition to the above, legal and reputation risks may arise from the conduct of insurance activities on the Internet. Without proper attention to the former, transactions may conceivably be repudiated or deemed null and void.

10. Internet operations are highly dependent on system reliability and integrity. Insurance supervisors should require that insurers and intermediaries apply effective internal control mechanisms to their insurance activities on the Internet. In particular, they should require that supervised companies that offer insurance services over the Internet have sufficient control systems in place (including security, confidentiality, control of personal data, back-up and record-keeping systems) to transact that business in a proper manner. Supervisors should look closely at any outsourcing arrangements to ensure that appropriate contracts are in place and that risks are being addressed effectively.

11. IAIS members are encouraged to adopt and implement the following principles:

Principle 1: Consistency of approach

The supervisory approach to insurance activities on the Internet should be consistent with that applied to insurance activities through other media.

12. Insurance supervisors should seek to apply standards of consumer protection to Internet-related activities of insurers and intermediaries equivalent to those applied to the provision of services off-line. They should not constrain the legitimate use of the Internet.

13. Insurance supervisors should be prepared to provide guidance on the circumstances under which they will seek to assert supervisory authority over Internet activities. Factors that may support an assertion of authority may include evidence that:

a. an Internet site is targeted at residents and/or risks within the supervisor's jurisdiction
b. insurance services are, in practice, being provided via the Internet site to residents in the supervisor's jurisdiction
c. attempts are made to present information to potential policyholders within the supervisor's jurisdiction through proactive means, e.g. e-mail.

14. Factors that may support a decision not to assert supervisory authority over Internet activities may include evidence that:

a. the insurer or intermediary clearly states that the services are offered to persons and risks outside the supervisor's jurisdiction
b. the Internet site contains a list of those jurisdictions in which the insurer or intermediary is entitled to provide services and the list does not include the supervisor's jurisdiction
c. the insurer has in place effective systems and procedures that are designed to prevent sales to residents in the supervisor's jurisdiction.

Principle 2: Transparency and disclosure

Insurance supervisors should require insurers and intermediaries over which they exercise jurisdiction to ensure that the principles of transparency and disclosure applied to Internet insurance activities are equivalent to those applied to insurance activities through other media.

15. The level of consumer protection should not be dependent on the medium used for insurance activities. The same basic principles of transparency and disclosure should apply for the Internet as for other media.

16. For example, the information provided to consumers should be broadly equivalent to that which would be expected in a traditional transaction, and should always be adequate for a consumer to make an informed decision on whether or not to avail of the services offered.

17. In order to protect the consumer, insurance supervisors should require that insurers and intermediaries over which they exercise jurisdiction and which offer insurance products over the Internet display certain minimum information on their Internet sites. In addition to the information that is mandatory in the jurisdiction in which services are being offered, the minimum information should generally include:

a. the address of the insurer's head office, and the contact details for the supervisory authority responsible for the supervision of the head office
b. contact details for the insurer, branch or intermediary, and for the supervisory authority responsible for the supervision of the business, if different from the above
c. the jurisdictions in which the insurer or intermediary is legally permitted to provide insurance services
d. procedures for the submission of claims and a description of the insurer's claims handling procedure
e. contact information on the authority or organisation dealing with dispute resolution and/or consumer complaints.

Principle 3: Effective supervision of Internet activities based on cooperation

Supervisors should cooperate with one another, as necessary, in supervising insurance activities on the Internet.

18. The regulation of Internet activities based purely on actions capable of being taken within a single jurisdiction is often inadequate. It is evident that the regulation and supervision of Internet activities requires a greater degree of cooperation amongst insurance supervisors. Therefore insurance supervisors should have the ability to cooperate with one another, for example in providing assistance when needed or in dealing with cases of abuse in each other's markets.

19. The exchange of information between supervisory authorities is a key element in pursuing effective supervision of Internet activities. The Internet can be an effective tool for exchanging basic information.

20. Insurance supervisors should generally make the information listed below available on their own websites:

a. Structure and organisation chart of the supervisory authority, including contact information
b. A listing of relevant insurance legislation
c. A list of supervised insurance and reinsurance companies, including contact information or a central point within the supervisory authority from whom such information can be easily obtained
d. A link to the website of the IAIS.

21. Insurance supervisors may also consider making available the information listed below available on or through their own website:

a. Texts of the relevant insurance legislation
b. A list of licensed intermediaries, including contact information, or a link to such a registry
c. The Annual Report of the supervisory authority
d. Annual insurance statistics
e. Links to the websites of other relevant supervisors in the same jurisdiction
f. Other information, as the supervisor deems relevant.

Principles No. 5

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

PRINCIPLES ON CAPITAL ADEQUACY AND SOLVENCY

January 2002

Principles on Capital Adequacy and Solvency

This document sets out principles that should serve as the basis for solvency regimes. The terms capital adequacy and solvency regime are defined in Paragraph 25.

The paper takes into account details set out in the Issues Paper on Solvency, Solvency Assessment and Actuarial Issues. It is anticipated that further work, which may lead to standards and guidance papers, will be undertaken on each principle.

Contents

I. Background

1. The IAIS Insurance Core Principles (October 2000) describes capital adequacy, inter alia, as an area that has to be addressed in the legislation or the regulations laid down by the insurance regulatory authorities or other competent bodies in each jurisdiction.

2. The purpose of supervising insurers is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. Capital adequacy and solvency regimes is one of the most important elements in the supervision of insurance companies.

3. An insurance company is solvent if it is able to fulfil its obligations under all contracts under all reasonably foreseeable circumstances.

4. Insurance regulatory authorities require insurers to maintain assets or surplus capital in excess of liabilities, that is, a solvency margin.

5. The Principles on Capital Adequacy and Solvency as set out in this paper are applicable to all insurance companies and are relevant for evaluating the solvency of life insurance undertakings and non-life (or general) insurance undertakings. The extent to which the principles will be directly applied with respect to reinsurers will depend on the degree of regulation of the reinsurance industry within the relevant jurisdiction.

6. Adherence to these principles by insurance regulatory authorities does not eliminate the need for consumers to take the utmost care in assessing the risks and the suitability of an insurance product to their needs. Insurance companies should be required to disclose relevant information to the public.

7. In addition, the principles do not remove the need for an insurer to carefully manage the risks of the business it undertakes. A sound supervisory system has to combine capital adequacy and solvency regimes with requirements for risk management systems for risk reduction and mitigation. The purpose of the solvency margin is to provide a safety buffer against events that may occur that are outside the expected range of events for which risk reduction measures have been taken.

8. The supervision of individual insurance undertakings by the insurance supervisory authority remains the essential basis of insurance supervision. In addition the regime has to address other issues that arise as a result of membership of a group.

II. Principles on Capital Adequacy and Solvency of Insurers

Principle 1:	**Technical provisions** Technical provisions of an insurer have to be adequate, reliable, objective and allow comparison across insurers

9. Adequate technical provisions are the cornerstone of a sound capital adequacy and solvency regime. Accordingly, technical provisions have to be calculated in a reliable, objective and consistent manner across insurers.

10. The methodologies and accounting practices used in establishing the technical provisions and in the treatment of the assets, particularly those available to cover the technical provisions, have to be considered when forming the solvency requirements that build upon the technical provisions. As noted in Principle 6, the capital adequacy and solvency regime needs to take into account the valuation of liabilities including the technical provisions.

11. Technical provisions should be valued on a prudent and transparent basis. The technical provisions have to be adequate to meet the obligations to policyholders. An insurer has to have regard to its own experience and, where appropriate, market experience in determining its

technical provisions. The technical provisions should include allowance for outstanding claims, for future claims and guaranteed benefits for policies in force, as well as expenses.

12. Reliability and comparability of technical provisions is enhanced by the use of experts.

13. The objective assessment of provisions means an unbiased assessment using an objective process, even though the valuation of insurance business includes some uncertainty in the estimation of claims.

Principle 2: Other liabilities

Adequate provisions must be made for all other liabilities insofar as they are not included in the technical provisions

14. Supervisors should ensure that an insurer makes adequate provisions for all of its liabilities. This may include obligations to third parties and amounts owed that are in dispute.

Principle 3: Assets

Assets have to be appropriate, sufficiently realisable and objectively valued

15. Insurance companies have to invest having regard to safety and return. The assets also must be sufficiently diversified and spread and should secure liquidity of the insurance company in order to ensure that the liabilities under insurance contracts can be fulfilled as they fall due.

16. For example, assets held with related parties on a non-commercial basis and intangible assets may not be readily marketable, may have a value other than that which can be used to fulfill policyholder obligations, or may be unavailable due to encumbrances, special privilege or other third-party interests, and therefore, are generally inadmissible or not available for solvency purposes.

17. The regulatory framework or insurance supervisory authority may impose other requirements on the assets to allow for items such as:

a. concentration risk;

b. credit risk;

c. market risk;

d. liquidity risk; and

e. liquidation risk.

18. In dealing with concentration risk, supervisory rules may prohibit the holding of an individual asset or a class of assets in excess of a certain level. Alternatively, rules may not

limit such holdings. In the case where concentrated holdings are permitted, the capital and solvency regime should ensure that only a certain level of the holding is able to be counted toward meeting the capital adequacy and solvency requirement.

19. Objective and consistent valuation of assets is based on prudent and transparent accounting standards and practices and can be enhanced by the use of experts.

20. Solvency and capital adequacy regimes must take account of the basis used in the valuation of the assets. Prudent accounting standards and practices should be encouraged.

Principle 4: Matching

Capital adequacy and solvency regimes have to address the matching of assets with liabilities

21. The capital adequacy and solvency regimes should address the risk of loss arising from mismatches in the:

a. currency;

b. timing of cash flows; and

c. amount of cash flows,

of the assets and the liabilities of the insurer adjusted to take account of off-balance sheet exposures.

Principle 5: Absorption of losses

Capital requirements are needed to absorb losses that can occur from technical and other risks

22. Insurance companies must be able to evaluate the risks that they underwrite and to establish an adequate level of premiums. Nevertheless, under-pricing can occur by underestimating the risks, changes in the claims experience, or inadequate underwriting. Insurance companies need to have sufficient capital to absorb the unforeseen losses which can result.

23. This capital is also needed to absorb losses from other risks including other technical risks.

24. Among the risks that capital adequacy and solvency regimes should have regard to include:

a. other current technical risks (including deviation risk, risk of error, evaluation risk, reinsurance risk, operating expenses risk and risk associated with major or catastrophic losses or accumulation of losses caused by a single event);

b. special technical risks (including liquidation risk and the risk of excessive or uncoordinated growth);

c. operational, market, organisational and conglomerate risks; and

d. investment risks (including risks related to the use of financial derivative instruments and also depreciation, liquidity, matching, interest rate, evaluation and participation risks).

Principle 6: Sensitivity to risk

Capital adequacy and solvency regimes have to be sensitive to risk

25. The capital adequacy and solvency regime comprises the:

a. valuation of liabilities (including the technical provisions);

b. requirements on assets (including requirements for valuation of assets);

c. definition of appropriate forms of capital; and

d. required solvency margin.

26. The valuation of assets and liabilities depends on the accounting framework of the jurisdiction.

27. The required solvency margin should reflect risks not taken into account in valuing liabilities and requirements on assets. This includes off-balance sheet exposures.

28. The capital adequacy and solvency regime as a whole has to be related to the risk faced by an insurer and should remain adequate at all times as this risk changes over time.

29. Supervisors may consider the use of internal capital models as a basis for a capital requirement as long as this model is assessed as adequate for the purpose by the supervisor.

Principle 7: Control level

A control level is required

30. Insurance regulatory authorities have to establish a control level, or a series of control levels, that trigger intervention by the authority in an insurer's affairs when the available solvency falls below this control level. These control levels may be supported by a specific framework or by a more general framework providing the supervisor a latitude of action.

31. The control level has to be set sufficiently high to allow intervention at an early enough stage in an insurer's difficulties for there to be a realistic prospect that this action might rectify the situation.

32. The supervisory regime must provide for some means for the orderly exit of insurers from the market and for clearly identifying or establishing the status of policyholders vis-a-vis other creditors.

Principle 8: Minimum capital

A minimum level of capital has to be specified

33. The regulatory framework has to set out a threshold minimum capital requirement for companies.

34. This minimum level of capital is designed to provide a minimum assurance of the financial capacity and soundness of the insurer.

35. The amount of the minimum capital should take into account the types of risk that are intended to be covered. The required minimum capital should by no means be used to compensate for normal foreseeable fluctuations in the development of certain risks. Nor should the setting-up costs of a new enterprise be covered by this minimum capital. Insurance regulatory authorities may impose a higher level of initial capital on the start-up of an insurer to support the business during its formative years.

Principle 9: Definition of capital

Capital adequacy and solvency regimes have to define the suitable form of capital

36. The capital adequacy and solvency regime has to define the form of capital that is deemed suitable to provide support when an insurer encounters an unexpected or extreme event.

37. In determining the form of suitable capital, insurance regulators should consider the extent to which the capital element:

a. represents a permanent and unrestricted investment of funds;

b. is freely available to absorb losses;

c. does not impose any unavoidable charge on the earnings of the insurer; and

d. ranks below the claims of policyholders and other creditors in the event of the insurer being wound up.

38. The regulatory framework has to set limits on the amount of capital instruments that may be counted toward capital adequacy and solvency requirements where they do not fully meet the criteria of paragraph 37.

Principle 10: Risk Management

Capital adequacy and solvency regimes have to be supplemented by risk management systems

39. The required solvency margin has to be considered the last resort after all other measures taken by the insurer to secure its financial stability have failed. The insurer also has to have in place risk management systems appropriate to the complexity, size and mix of the insurer's operations.

40. These risk management systems have to be comprehensive and cover all risks to which the insurer is exposed. These risk management systems have to be supported by comprehensive monitoring and internal control systems. Risk management systems have to be supported by the regulatory framework, the insurance supervisory authority and, if applicable, the use of experts.

Principle 11: Allowance for reinsurance

Any allowance for reinsurance in a capital adequacy and solvency regime should consider the effectiveness of the risk transfer and make allowance for the likely security of the reinsurance counterparty

41. Reinsurance arrangements are a primary tool for risk transfer. Any credit for reinsurance should consider the effective transfer of insurance risk under the contract of reinsurance.

42. Where allowance is made for reinsurance in determining the valuation of technical provisions, the reinsurance has to be assessed with regard to adequacy, reliability, objectivity and consistency.

43. The likely security of the reinsurance counterparty has to be considered in determining whether, and to what extent, allowance should be given for reinsurance.

Principle 12: Disclosure

The capital adequacy and solvency regime should be supported by appropriate disclosure

44. Insurers should be required to publicly disclose appropriate qualitative and quantitative information about risk exposures and the components that make up their capital.

45. The disclosure of appropriate risk exposures increases the ability of the financial markets, and to a lesser extent, consumers to make judgements about dealing with a particular insurer. In addition, it encourages insurers to adopt sound risk management policies and practices.

Principle 13: Solvency assessment

Insurance supervisory authorities have to undertake solvency assessment

46. Insurance supervisory authorities have to consider the following elements when undertaking solvency assessment:

a. the adequacy, reliability, consistency and objectiveness of technical provisions, assets and liability valuations and statutory reporting;

b. compliance with the required solvency margin and control levels;

c. the adequacy of the internal risk assessment processes of the insurer; and

d. the risk management systems of the insurer.

47. It is the responsibility of the Board of Directors and senior management of an insurer to manage its risks. If efficient control systems are not in place to monitor risk exposures, an insurer will not be able to adapt quickly enough to changing market situations.

Principle 14: Double gearing

Capital adequacy and solvency regimes have to address double gearing and other issues that arise as a result of membership in a group

48. Capital adequacy and solvency regimes for insurers that are part of a group also should take a group-wide view. When considering insurance companies that are part of a group, it is important that steps are taken to avoid double gearing of capital.

49. Consideration should be given to the capacity for intra-group funding.

50. For an insurance group, the treatment of transactions between members of the same group should be considered as part of a capital adequacy and solvency regime.

51. In addition, insurance supervisors should consider reputation and contagion risk that may arise as a result of problems in an associated company.

Principles No. 6

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

PRINCIPLES ON MINIMUM REQUIREMENTS FOR SUPERVISION OF REINSURERS

October 2002

Principles on Minimum Requirements for Supervision of Reinsurers

This paper sets out principles on minimum requirements for supervision of pure reinsurers.[1] It identifies elements of the supervisory framework that should be common for primary insurers and reinsurers and those elements that need to be adapted to reflect the unique risks faced by reinsurers.

Captive insurers often operate as reinsurers. As a result, they are included in the scope of this paper. However, where captives only insure the risks of their owners and are part of the same organisation they may not pose the same risk to the financial system and separate regulations may be established recognising this reduced risk.

Contents

I. Introduction

1. Reinsurers contribute to the stability of insurance markets. They can improve the risk profile and the financial soundness of primary insurers by diversifying and limiting territorial accumulations of exposure, and consequently creating underwriting capacity. However, to have this stabilising effect these entities must be able and willing to meet their obligations as they fall due.

[1] While this paper addresses the minimum requirements for supervision of pure reinsurers the IAIS database of reinsurers include insurers who provide a significant amount of reinsurance business. The principles described in this paper will, with the necessary adaptations, also be applicable to insurers whose main activity includes the issuance of reinsurance coverage

2. Reinsurers offer cover through traditional means or through certain alternative risk transfer products (ART). They provide services across borders either directly or by establishing subsidiaries or branches. While reinsurers operate on a global basis, their business has to take account of the location of the risks, types of business or differences in regulation among jurisdictions.

3. Currently, reinsurers in some jurisdictions are fully or partly directly supervised; other jurisdictions rely on rating agencies in assessing the security of a reinsurer. Some supervisors maintain a register of those reinsurers authorised to underwrite reinsurance in their jurisdiction, while others evaluate reinsurers writing business in their jurisdiction. Some jurisdictions require reinsurers to post collateral, covering the likely liabilities (or liabilities plus a margin). In most jurisdictions, a reinsurer who also acts as a primary insurer is subject to direct supervision.

4. Internationally recognised principles for the supervision of reinsurers are needed because of the global nature of the business and the expectation that the business will continue to expand, for example into new regions. They are also needed to ensure that new entrants in the reinsurance markets or existing entities that expand their business rapidly offer acceptable security.

5. There is an on-going need for insurers to assess the security of the reinsurers with whom they deal.[2] Supervisors of primary insurers also need access to information on the reinsurers of their authorised insurers, including information on whether these reinsurers are subject to effective supervision elsewhere[3].

6. Recognising that there will always be some differences in the supervisory regimes, this principles paper identifies minimum requirements for supervision of reinsurers. These requirements should be supplemented by effective systems for exchanging information. It is assumed that the move towards global principles will be an evolutionary process especially because, in a number of jurisdictions, the supervisor presently lacks the powers or the resources to supervise pure reinsurers.

7. The minimum requirements anticipate a global approach to the regulation of reinsurers. In such a system, the onus is placed on the home supervisor of the reinsurer. The home supervisor is responsible for effective supervision of the business and is responsible and expected to communicate effectively with supervisors in other jurisdictions where the reinsurer writes business. In the interest of policyholders and by improving comparability, minimum requirements could help define a minimum level of acceptable security of reinsurers[4]. Within the framework of the global approach some form of accreditation of home supervisors will be necessary. In addition, the minimum requirements and standards for accreditation should be at such a sufficient level so that host supervisors can reasonably be expected to see no need for additional requirements.

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2 Cf. the *OECD Recommendation of the Council on Assessment of Reinsurance Companies*, C(98)40/FINAL.

3 Cf. *IAIS Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers*, January 2002.

4 Cf. *IAIS Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers,* January 2002.

8. The development of an efficient global approach to regulation of reinsurers may present advantages to reinsurers, primary insurers, and, therefore, to policyholders. These would include greater risk diversification, more effective use of available capital, minimalisation of duplicative regulation, and the reduction of alternative methods for assessing the recoverability of reinsurance claims.

9. The minimum requirements for the supervision of reinsurers naturally differ from those for primary insurers. Conduct-of-business rules do not apply, since the policyholders of reinsurers are not consumers and do not require the same protection. Jurisdictions supervising reinsurers should apply principles reflecting the characteristics of the reinsurance business and the types of risks entailed (particularly in relation to their financial strength). Regulation should take account of and reflect best practices in the industry. It should not stifle innovation that would improve the efficiency and stability of the reinsurance market.

10. Principle 1 describes where supervisory requirements and practices for reinsurers differ from those applied to primary insurers because of the characteristics of the business undertaken. Principle 2 identifies where the same methods can be applied.

II.

Principle 1:	**Regulation and supervision of reinsurers' technical provisions, investments and liquidity, capital requirements, and policies and procedures to ensure effective corporate governance should reflect the characteristics of reinsurance business and be supplemented by systems for exchanging information among supervisors**

Technical provisions

11. Supervisors should have the ability to assess the adequacy of procedures used by reinsurers to establish their liabilities.

12. Supervisors should take into consideration limitations that reinsurers face. For example, they largely depend on information from primary insurers in establishing technical provisions. As a result there may be significant delays in receiving claims information. Thus, it is particularly important that the reinsurers have adequate systems for establishing provisions for claims incurred but not reported or incurred but not enough reported (known as IBNER)[5]. Generally, reinsurers and primary insurers use similar actuarial methods to establish and review their IBNR and IBNER provisions. However, the exercise can be more complicated for reinsurers because of non-homogenous portfolios, long tail classes, or information delays. Often, it is necessary to review individual treaties.

[5] Some jurisdictions refer to these provisions collectively as IBNR; in other jurisdictions they are referred to separately IBNR and IBNER.

Investments and liquidity

13. Reinsurers, as well as primary insurers, must invest in assets that in terms of security, return, diversification and marketability are sufficient to cover their obligations as they fall due. Reinsurers' investment strategies are further complicated because often they need to manage and match assets and liabilities in a number of currencies and different markets. In addition, they may have to reimburse the large-scale losses of primary insurers on demand. Reinsurers need to have effective tools in place to manage their investments and liquidity risks and monitor their cash flows.

Capital requirements

14. In setting capital requirements supervisors should take into account risk profiles, including the volume of business and degree of diversification. The higher a company's sensitivity to risk, the greater the need for it to have strong risk management practices and capital to shore up its financial strength. Significant risks faced by reinsurers include **underwriting** (including cumulations and geographical diversification), **retrocession**, **investments** (liquidity and currency matching), **taxation**, and, for reinsurers in a group, **group risk**. In addition, like primary insurers, reinsurers are exposed to a variety of operational risks the sources of which could be employees (e.g., human error and internal fraud), technology (e.g., technological failure and deteriorating systems), customer relationship (e.g., contractual disputes), and external (e.g., external fraud). Also since reinsurers' operating results are potentially more volatile than those of primary insurers, they must hold capital reflecting the risks inherent in this type of business and sufficient to be able to withstand extreme but plausible loss scenarios.

15. Reinsurers may use dynamic financial analysis tools or other risk models to determine the required economic capital[6]. Supervisors should be knowledgeable about these tools and have access to expertise as necessary. Provided the models in the future are sufficiently reliable, and provided they meet supervisory standards and are properly controlled, they may be used to facilitate mutual recognition of capital requirements of reinsurers.

Corporate governance

16. Standards should be present to ensure effective corporate governance of reinsurers. For example, there should be standards with respect to the roles and responsibilities of the board of directors.

17. In many respects reinsurers and primary insurers face the same problems. However, in the case of reinsurers some of the problems may be different and sometimes more acute and of greater magnitude. With this in mind, reinsurers should be required to have appropriate policies and procedures covering:

- underwriting (including counterparties' integrity, management and business policy);
- provisioning;

[6] This term is normally used to describe the capital needed to support a given risk profile of the company

- identification, handling and control of aggregates;
- cumulations (storm, quake, flood and hail);
- business line and geographical diversification;
- retrocession (cover and security);
- investments (including asset/liability matching and asset diversification);
- liquidity and cash flow; and
- currency matching.

18. In addition, the following IAIS Standards should be referred to: *Supervisory Standard on Asset Management,* December 1999; *Supervisory Standard on Derivatives*, October 1998; and *Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers,* January 2002.

Exchange of information on supervision of reinsurers

19. By exchanging information, supervisors can learn from each other's experiences. This is especially true given the international and the dynamic nature of reinsurance and ART business. In particular, supervisors should exchange information on supervisory methods and experience, including information and experience on catastrophes. Such exchanges will be subject to normal confidentiality provisions.

III.

Principle 2: Except as stated in Principle 1, regulation and supervision of the legal forms, licensing[7] and the possibility of withdrawing the licence, fit and proper testing, changes in control, group relations, supervision of the entire business, on-site inspections, sanctions, internal controls and audit, and accounting rules applicable to reinsurers should be the same as that of primary insurers

Legal forms

20. The law of the home jurisdiction should define the legal forms of reinsurance entities.

Licensing and the possibility of withdrawing the licence

21. Reinsurers must be licensed or authorised in their home jurisdiction before undertaking reinsurance activities. The supervisor has the right to revoke the licence if the company no

[7] Some entities are given permission to underwrite reinsurance through "authorisation"; in this paper the term licensing will include authorisation

longer fulfils the conditions for obtaining a licence, or is able, but not willing to fulfil its obligations. If the licence is revoked, the reinsurance company must stop writing new business.[8]

Fit and proper testing

22. Supervised reinsurers should be run by persons of good repute, with appropriate professional qualifications and experience. Thus, substantial owners, the board of directors and management should be subject to fit and proper tests. These tests should be made in accordance with the *IAIS Guidance Paper for Fit and Proper Principles and their Application*, October 2000.

Changes in control

23. The home jurisdiction supervisor should have the authority to approve or object to shareholders with material interests in reinsurers.

Group relations

24. Reinsurers in a group should be supervised on a consolidated or solo-plus basis[9], incorporating all activities that could have an impact on the financial position of the individual licensed entities. In particular, supervisors should assess capital adequacy, underwriting and other risk concentrations, and intra-group transactions including intra-group exposures on a group-wide basis. The following IAIS Standard may be referred to: *Supervisory Standard on Group Co-ordination,* October 2000. Reference is also made to the Joint Forum papers: *Capital Adequacy Principles,* February 1999, *Risk Concentration Principles,* December 1999 and *Intra-Group Transactions and Exposures Principles*, December 1999, and *Framework for Supervisory Information Sharing*, February 1999.

Supervision of the entire business

25. The home jurisdiction supervisor must make sure that all parts of the business of a reinsurer are subject to effective supervision. The supervisor should be able and willing to share relevant information with other insurance and reinsurance supervisors, subject to confidentiality rules.

On-site inspections

26. The supervisor should have the authority to carry out on-site inspections to review the business and affairs of the reinsurer, including the inspection of books, records and other

[8] Licensing should follow similar principles to those described in the *IAIS Supervisory Standard on Licensing, October 1998.8.* This Standard, however, refers to licensing of primary insurers only.

[9] The concept of solo-plus supervision implies that in addition to the solo or stand-alone supervision of regulated entities supplementary supervision should also be applied on a group wide basis. The supplementary supervision would normally include a review of the group's capital (ensuring that there is no double gearing or double leveraging), intra-group transactions or risk transfers (ensuring that they are conducted as if they were on an arm's length basis), risk concentrations, and co-operation among supervisors.

documents. The following IAIS Standard may be referred to: *Supervisory Standard on On-Site Inspections,* October 1998.

Sanctions

27. Supervisors must have the authority to take remedial action where problems involving licensed reinsurers are identified. The supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered, recognising reinsurers and primary insurers may face different problems. The powers available to the supervisor should be set out in legislation and/or statute. Where there are serious doubts about the ability of a company to continue operations, the supervisor would be expected to notify other relevant insurance and reinsurance supervisors, on the condition that these other supervisors would maintain the confidentiality of the information according to the rules of the home jurisdiction.

Internal controls and audit

28. The supervisor should be able to review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary.

29. The supervisor should require accounts to be audited by external auditors. In addition, the supervisor may require auditors to certify compliance with certain requirements.

Accounting rules

30. Accounting rules should be in line with those applicable to primary insurers and should include valuation principles. Since reinsurance is a global business and most entities operate in several jurisdictions, all reinsurers should use similar accounting principles.

Access to non-public information

31. It is important that reinsurance supervisors have access to and receive information necessary to form a proper opinion on the risk profile of each reinsurance company domiciled in their jurisdiction. The information needed to carry out this review and analysis should be obtained from the financial and statistical reports, including accounts that are filed on a regular basis and supported by information obtained through special information requests, on-site inspections and communication with actuaries and external auditors. All reinsurance supervisors should be subject to confidentiality constraints in respect of information obtained in the course of their activities, including the conduct of on-site inspections.[10]

[10] Cf. IAIS Supervisory Standard on the Exchange of Information, January 2002.

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON LICENSING

October 1998

Supervisory Standard on Licensing
Report from the IAIS Technical Committee

Licensing plays an important role in ensuring efficiency and stability in the insurance market. Strict conditions governing the formal approval of insurance companies are necessary to protect insurance users. The licensing process may also help ensure that fair competition exists among companies in the market.

The "Insurance Supervisory Principles" (level-one standards) adopted by the IAIS contain general principles which are attached as an Annex to this standard.

Given the framework of these general principles, this standard contains requirements that should be met by an insurer seeking a licence, as well as principles that apply to the licensing procedure itself, including the review of changes in the control of a licensed company. In some instances the standard goes beyond issues strictly related to "licensing" and may need to be revised in the future as new supervisory standards dealing specifically with these issues are prepared.

This standard deals with the prudential aspects of licensing. Although there may also be other aspects to consider in the licensing process, this standard does not deal with them.

The IAIS recognises that member countries have different legal and supervisory structures and supervisors may need to adapt this standard to their particular circumstances.

Table of Contents

I. Background

1. The provision of private insurance is a very important economic activity. Insurance increases for instance the credit standing of a company and hence its funding potential. It offers certainty of planning, thus making technical progress possible. By compensating for losses, it maintains the production capacity and may consequently prevent unemployment. Life insurance plays a significant economic role in mobilising personal savings.

2. Compared to other sectors of the economy, however, insurance takes up a special position. All the insurer offers in return for the insurance premium already received is in many cases the mere promise to perform its services if a claim arises in the future. Therefore, the policyholder must be able to trust the insurer to be able to keep this promise if the insured event occurs. The failure of one insurer could have negative consequences for the entire sector. A disturbance in the relationship between the policyholders and their insurance company could affect the public confidence in the financial system.

3. The role of supervision by or on behalf of the state is to ensure that insurance companies are able at any moment to fulfill their obligations and that the interests of the policyholders are sufficiently safeguarded. The licensing procedure is the first step towards achieving these objectives. It is one of the most important elements of the supervisory system. If the licensing procedure as well as the on-going supervision of licensed insurers meet internationally accepted standards, confidence in the supervisory systems will grow on a domestic level as well as on an international level. Such confidence may facilitate mutual recognition of national supervisory systems and thus the liberalisation of market access for foreign insurers.

II. Definitions

4. The following definitions apply to the terms used in this paper:

Branch:[1] part of a company, not being a separate legal entity, established in a jurisdiction other than the company's home jurisdiction. In some jurisdictions there may exist other forms of permanent presence (e.g. agency).

Cross border provision of services:[1] provision of insurance on a services basis (without local establishment) in a jurisdiction other than the company's home jurisdiction.

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1 These terms do not always apply in the sense given here when jurisdictions within states with a federal structure are concerned. In such cases cross border refers to crossing the borders surrounding the jurisdictions of the federal structure but not inside it.

2 These terms do not always apply in the sense given here when jurisdictions within states with a federal structure are concerned. In such cases foreign refers to jurisdiction surrounding the federal structure but not jurisdictions inside it.

Domestic/foreign:[2] 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.

Home jurisdiction: jurisdiction in which an insurer has its head office.

Host jurisdiction: jurisdiction in which a foreign insurer operates by way of a local branch or on a services basis without local branch.

Home/host supervisor: supervisor of the home/host jurisdiction.

Jurisdiction: jurisdiction refers to 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 state with a federal structure, e.g. the states making up the USA.

Qualifying participation: a participation held directly, or indirectly through one or several subsidiaries, by a natural or legal person, of at least X % in the company, or – also in the case of a lower percentage – a participation enabling the shareholder to substantially influence the company's management. X is defined in accordance with domestic law (10 % or 20 % are common threshold values).

III. General licensing principles

The term "licence" in this paper – scope of application

5. In this paper, licence refers to the authority to operate business in the domestic market which under domestic law:

- is defined as insurance business;
- is based on contracts between the company offering the business and the policyholders; and
- is subject to supervision by the competent authorities.

6. Licence refers only to the formal authority to operate business in the meaning of the domestic supervision law, it does not refer to approvals in the meaning of the general trade or company law.

7. The following sections apply to direct insurers that also may accept ceded business, but not to pure reinsurers. This paper does, however, apply, unless stated otherwise, to foreign insurers who operate by way of establishment or on a services basis without local establishment. This paper does not deal with the licensing of natural or legal persons intermediating insurance.

Types of company which must be licensed

Domestic insurers

8. Legal entities operating direct insurance business as defined in the respective insurance supervision law should always be licensed, irrespective of their area of operation. As to the exceptions, see paragraphs 15-17 below.

Foreign insurers

9. There are two ways in which foreign insurers may operate:

a. by a local branch; and
b. on a services basis.

As a rule, the licence should be given by the host supervisor if the insurance business is to be operated by one of the two above methods. As an option, however, a foreign insurer may be allowed to operate only by setting up a branch in the domestic market.

10. Before giving a licence the host supervisor should at least be provided documentation including:

- the name and address of the place of incorporation;
- the types of insurance which the company proposes to write;
- confirmation from the home supervisor that the company is indeed authorised to carry on the types of insurance business proposed;
- confirmation by the home supervisor that the company is solvent and meets all the regulatory requirements in the home jurisdiction; and
- additionally, in the case stated in paragraph 9a above, name and address of the branch and the authorised agent in the host jurisdiction. The licensing requirements in section IV below apply when appropriate. See also principle 3 of the Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Establishments, issued by the IAIS in 1997.

11. A foreign insurance company may be allowed to operate, without an approval from the *host* supervisor where, for example, bilateral or multilateral agreements are in place which ensure that the company:

- is subject to supervision in its home jurisdiction which has been recognised as adequate by the host jurisdiction; and
- may be subject to sanction if it does not meet the legal provisions of the host jurisdiction.

Subsidiaries of foreign companies

12. Companies which are incorporated in accordance with domestic law but which are partially or wholly foreign-owned subsidiaries should in principle meet the same licensing requirements as domestic insurers.

Types of business which must be licensed

Insurance business

13. "Insurance business" in this paper is understood to mean such business as is to be called insurance in accordance with *domestic* law. It is obvious, however, that different interpretations of insurance business could lead to supervisory problems, especially where cross-border operations are concerned.

Distinction between insurance and social security

14. This paper does not deal with companies or types of business which are part of the social security system. However, in some jurisdictions it may be possible for people to replace coverage under the social security system by concluding an insurance contract (e.g. for pensions) offering protection equal to that provided by the social security system. This paper deals with these "substitutive" insurances, as well as with private insurance of a social and/or compulsory nature (e.g. medical health insurance, third party liability insurance for motor vehicles and personal pension insurance).

Insurance business which may not be licensed

15. *Small mutual societies* whose activities are limited to a certain geographical area and/or limited to a certain number of policyholders and/or who offer special types of cover (death benefit, livestock insurance) may not be licensed in some jurisdictions. The reasons for this fact could be that the insured sums do not exceed certain amounts, or that losses are compensated by payments in kind, and that the activities are pursued following the idea of solidarity.

Correspondent insurance

16. Where insurance contracts are concluded with an insurer in another jurisdiction on a services basis without the initiative of this insurer, the latter may not have to be licensed in the country of his client.

Products which are not offered by licensed domestic insurers

17. Sometimes, certain very specific risks situated in the country are not covered by domestic insurers. This may concern specific large risks (nuclear energy, natural disasters) or very specific personal risks (e.g. professional indemnity). For cases like these, i. e. where an 'insurance shortage' is concerned, the domestic law can provide that these risks may be covered by foreign insurers without these insurers requiring a licence.

The domestic law may similarly permit maritime shipping, commercial aviation and goods in international transit to be insured by foreign insurers without these requiring a licence.

Scope of licence

18. *Regarding activities*: Since the application for a licence is examined on the basis of having information on the proposed types of business, the licence should take into account classes of insurance which are to be operated and may be applied for and granted with respect to particular classes of insurance. As regards classification, domestic law should categorise insurance business into types and classes of insurance (at least into life and non-life). In doing so, it may rely on internationally accepted classifications (e.g. OECD classifications).

19. *Regarding period of time*: A licence should in principle be granted for an unlimited period, given that insurance is by nature a long-term business. Renewing the licence at regular intervals (e.g. annually) could however be an effective measure for the supervisor to ensure that the business of a new insurance company develops in the course of the first few years according to the business plan (see paragraphs 32-36 below).

VI. Licensing requirements

Preliminary remark

20. Active business life of an insurance company starts once the licence has been granted or, if registration is required *after* the licence has been granted, once the registration has been accomplished. During its course the company is subject to on-going supervision. The requirements which were preconditions for granting a licence should be met at all times during the on-going business operations. This applies to capital adequacy, suitability of managers and owners, adequate reinsurance etc. The supervisor should also always be able to obtain information on the type of business operated.

Legal form and head office of the company

21. Each jurisdiction should *define* the permitted types of legal form. Such legal forms should provide a certain stability of the company, as well as enable the creation of own funds, e.g. joint-stock company and mutual society.

22. Legislation should require that the location of the head office and also its central administration be situated within the home jurisdiction where the licence was granted.

Objective of the company

23. Insurance companies should not carry on any activities other than in connection with or for the purposes of their insurance business. Operation of business not related to insurance may

be allowed as an exception only in limited and defined circumstances.

24. The objective of the company should be defined in the company's articles of incorporation.

Specialisation

25. A company licensed to operate life insurance should not be licensed to operate also non-life insurance and vice versa (principle of specialisation), unless there are clear provisions, satisfactory to the supervisor, to handle a separation of risk on both a going concern and winding-up basis. As an exemption from this principle, however, the operation of other classes of personal insurance (e.g. accident, health) together with life insurance could be authorised.

26. Companies already doing business of both kinds ("composite companies") may continue to do so, provided they maintain separate book-keeping and accounting for life and non-life insurance operations and provided they take appropriate steps to ensure that life insurance policyholders are not at risk from losses in the non-life sector and vice versa.

27. Specialisation may not prevent a non-life insurer from taking substantial shareholdings in a life insurer (or vice versa). Regulation should, however, provide that the surplus resulting from prudential assumptions in life insurance is not diminished in a way that affects the reasonable expectations of the policyholders.

Minimum capital

28. An important licensing requirement is the establishment of sufficient free capital. This is an absolute amount fixed by the supervisor or by law (minimum capital). The amount of the minimum capital should take into account the type of risk that is intended to be covered. If the applicant company proposes to write several classes it is possible either to require the highest of the amounts fixed for the individual classes or to add up the amounts of the individual classes.

29. The required minimum capital should by no means be used to compensate normal foreseeable fluctuations in the development of certain risks. It should be uncommitted so as to be available if unforeseeable losses of any kind are to be covered. Nor should the setting-up costs be covered by this minimum capital. For additional financial requirements, see paragraph 35 below.

30. Proof of the minimum capital should be submitted to the supervisor. The elements making up the minimum capital should be shown as part of the proof.

31. In order to ensure the guarantee function of the minimum capital, legislation could require a deposit. The company may only dispose of this deposit with the supervisor's approval.

Business plan

32. The supervisor is to request the submission of a business plan describing the proposed business of the company for at least three years ahead. This plan should demonstrate satisfactorily that the company will be able to maintain a sound financial situation and meet its obligations at all times during the first years. The business plan should include the following information and proofs:

the types of obligation the company proposes to incur (life insurance) or the types of risk it proposes to cover (non-life insurance)

33. This information is particularly important for determining the amount of the financial resources the company should possess during the initial stages. It should not be restricted to the indication of the classes of insurance according to the national classification. Instead, the nature of the risks and the target group with which the company intends to conclude the contracts should be described in as detailed a manner as possible (see also section "Product Control" below). The company should provide information on whether it also proposes to accept reinsurance business, and if so, in which insurance classes.

the basic principles of the company's reinsurance policy

34. The company should describe how and to what extent the expected contracts are to be reinsured. Prudent founders will at this stage already have consulted with reinsurance companies and be able to present a reinsurance programme. The supervisor should be convinced that the reinsurance company has sufficient security or has pledged securities for the insurance company.

the estimated setting-up costs and the financial means to be used for this purpose

35. The company should describe how the structures needed to manage the expected portfolio of contracts are to be set up and through which channels (e.g. brokers, agents, distribution outlets) the products offered are to be distributed. The costs which will be incurred, depending on the intended development of the business, should be estimated. At the same time the company should prove that the financial means required for covering the setting-up costs will be available (organisation fund or equivalent).

projected development of business and solvency margins

36. The company should present for at least three years a projection of the expected development of business in the form of model profit and loss accounts. Simplified balance sheets and the expected liquidity situation should be considered on the basis of the same assumptions on business volume and structure, premiums, commissions, administrative expenses and claims expenses, investment income, and tax. The supervisor should be able to examine the projections to determine whether they are

realistic. It may if necessary require a review of assumptions, an increase of the organisation fund or equivalent, a different method for the calculation of premiums, or a different reinsurance policy. If the applicant company does not take account of the supervisor's objections, the supervisor may refuse the licence, or grant it subject to certain conditions, e.g. with respect to net risk retentions.

Suitability of directors and/or senior management

37. The managers of an insurance company should be suitable, since problems in the insurance industry are often due to mismanagement caused by personal and professional inappropriateness of directors and/or managers. Therefore, the supervisor should carefully check the suitability of directors and/or senior managers. The following criteria should be taken into account:

a. *directors/senior managers must be professionally qualified.* Professional qualification requires theoretical and practical knowledge in insurance as well as managerial experience. These requirements can be deemed met if an activity of several years for an insurance company of the same kind and size can be proven. Expert knowledge may, however, also have been acquired outside the insurance industry if the person concerned has occupied a managerial post. The requirements should, however, depend on the area for which the person concerned will be responsible (e.g. data processing, personnel, fund management etc.);
b. *directors/senior managers must be reliable and of good repute.* Reliability refers to a person's character. In assessing the latter, the supervisor should base its judgement on known facts and evidence. A reason to deny the licence would be if the supervisor had knowledge of facts from which it could be deduced that the person concerned will not manage the insurance company in a due fashion (previous conviction especially for an offence committed in connection with financial services; participation in unsound transactions; bankruptcies caused by dishonesty; tax evasion); and
c. if, in special cases, senior management functions (e.g. authorised representative of a foreign branch) are performed by a company (legal person), the representatives of that company should meet the requirements under a) and b) above.

38. In order to enable the supervisor to check if the above conditions are met, the applicant may be required to submit a complete curriculum vitae of the proposed directors/senior managers signed in their own hand providing the following information:

- names and surnames, date and place of birth;
- private address and nationality;
- professional education (training/studies including dates, schools and universities, diplomas);
- membership in professional organisations;
- full record of the professional career (including the names of all employers for which the person concerned has worked previously; and

– type and duration of the respective activities (department, responsibilities).

39. The applicant should provide a declaration from the proposed directors/senior managers confirming that no criminal proceedings are or have been pending against them. The supervisor may also require the applicant to submit further particulars on the professional career of these persons, e.g. by answering a questionnaire elaborated by the supervisor.

40. The authorised agent of a branch has to meet the above requirements depending on his/her area of responsibility.

Suitability of owners (Control of shareholders)

41. The supervisor should know the names of the natural and legal persons holding a direct or indirect qualifying participation in the applicant company. The supervisor should be convinced that they meet the demands made in the interest of the sound and prudent management of the insurance company and that they are reliable.

42. The licence to operate should be refused if facts exist from which it can be deduced that the holders of a qualifying participation.

- are in a difficult economic situation;
- are or ever have been directly or indirectly involved in illegal transactions affecting their suitability, or intend to abuse the insurer for criminal purposes (e.g. money laundering); and
- are connected with the applicant company in a way that would obstruct or render effective supervision impossible.

43. Criteria similar to those listed under the section "Suitability of directors and/or senior management" above should be applied to check the reliability of natural persons. If legal persons are concerned, the supervisor should be authorised to ask for submission of audit reports and extracts from the register of commerce. It should have the power to exchange information with other authorities inside and outside its jurisdiction which respect minimum reciprocity and confidentiality requirements.

44. In the course of its investigation, the supervisor should also check if the structures of the group the applicant company is part of are sufficiently transparent to the supervisor and will not be a source of weakness. The supervisor should have the authority to prevent corporate structures that hinder the effective supervision of insurance companies.

Affiliation contracts and outsourcing

45. Contracts regulating important relationships with other companies, transferring functions to other companies (outsourcing), influencing the financial situation of the company or being in some other way relevant for an effective supervision should be submitted in

compliance with the supervisor's requirements. If the supervisor objects to the contents of such contracts, and if these objections cannot be removed, the licence could be denied or revoked. An a priori submission of these contracts is preferable.

46. The supervisor should consider the following types of contract:

a. *affiliation contracts* through which a joint-stock company subjects itself to the management of another company (e.g. holding company), or commits itself to transfer its profits to that company. The supervisor should verify that the controlling company does not have any intervention rights that could be an obstacle to effective supervision;
b. *outsourcing contracts* outsourcing means to transfer certain functions of material importance, (e.g. investment management, distribution, informatics, accounting etc.) from an insurance company to another company which need not necessarily also be an insurance company. The supervisor should especially see to it that supervision of the outsourced functions is ensured. This can be done by one of the following methods:

   – in relation to the outsourced functions, the applicant company reserves any rights to issue instructions to and obtain information from the company accepting the functions; and
   – the supervisor should have the power, where appropriate, to carry out on-site-inspections on outsourced functions to check if activities are carried out in accordance with the supervisory rules.

47. If functions are transferred to a subsidiary or another company being part of the same group, the supervisor should review the suitability and security of the contractual arrangements.

48. The outsourcing of central functions of an insurance business (e.g. managing bodies, accounting, portfolio management etc.) to a company in another jurisdiction is admissible provided that the requirements in paragraph 46b above are fulfilled. Supervision of the outsourced function could for instance be ensured by an agreement with the authorities in the other jurisdiction.

49. Contracts to the effect that the applicant intends to render services to other companies should be checked as to whether such services are part of the insurance business or directly related to it. In the case of contracting parties which are both part of one group the requirements under paragraph 47 above apply accordingly.

Product control

50. Insurance companies should not be regulated more than strictly necessary regarding the design of their products. The supervisor should however be empowered to request precise

information on the products that are to be marketed. Information could for instance be required on the design of the products which a newly licensed insurance company intends to market; this in order to be able to assess risks and to judge if the managers to be nominated have the necessary qualifications and if the planned organisation structures are suitable for the administration of such products. Possibly, the financial guarantees that should be provided also depend on the type of products offered.

a. General policy conditions

51. Information on products may also include the general policy conditions, which could be submitted a priori, a posteriori or non-systematically on demand.

52. Provisions should be in place ensuring that the cover offered by compulsory insurance (e.g. motor liability) or contracts replacing coverage under the social security system (substitutive insurance) is adequate and in accordance with domestic law governing these sensitive areas.

b. Technical bases for the calculation of premium rates and provisions

53. The supervisor should be entitled to request precise information on the technical bases used for the calculation of premium rates and technical provisions. This is important with respect to all products, whether the premiums are calculated on the basis of actuarial principles or not. The technical bases of all or most of the products may be systematically checked, especially if the company is new to the market. In life insurance as well as in compulsory insurance and substitutive insurance, the law or the supervisor should recommend statistical bases or general calculation principles.

54. The supervisor should in the individual case have the power to check the calculation and the technical provisions itself or charge another person to do so (e.g. an actuary), and to intervene if solvency of the insurance company is jeopardised.

Articles of incorporation

55. The articles of incorporation of the insurance company should be submitted to, or may be issued by, the supervisor and if necessary approved by it. The articles of incorporation can include a description of the individual classes of insurance that are to be offered, the investment principles and an indication as to whether insurance is to be written directly only or also indirectly.

56. The purpose of the examination of the articles of incorporation is to verify that the provisions under the supervision law and the company law are observed.

Actuaries and auditors

57. If companies are required to appoint an actuary with specific responsibilities, the supervisor should confirm.

a. the qualifications, reliability and good repute of the person to be appointed. Insofar as a legal person is permitted to fulfill the duties concerned, information should be collected on its experience as well as on the qualification and reliability of the managers of this legal person.
b. the position of this person in relation to the management of the insurance company: It should be sure that the actuary – irrespective of whether he is employed by the company or free-lance – has sufficient powers and independence to duly fulfill his role.

58. If the applicant is required to appoint an auditor before the licence can be granted (e.g. for the purpose of an initial audit) the supervisor should confirm that the requirements described in paragraph 57a above are met.

V. Licensing procedure

Application

59. The company should submit an application if it intends to operate insurance. This application should include information on the types of business to be written. The application should also contain all the documents and information required by the supervisor to confirm that the requirements mentioned under section IV above are met.

Examination procedure

60. Supervisors are encouraged to issue written guidelines on how to file an application for a licence. These guidelines could include the licensing requirements set out by legislation and advise on the required format of documents, projections, initial audits etc.

61. To make the formal licensing procedure easier and prevent any unnecessary delays, the supervisor may encourage persons proposing to establish an insurance company to get in touch informally before applying for the licence. In preliminary talks, the founders of the company could be advised on how to prepare the documents which should be submitted with the application.

62. In assessing the application documents, the supervisor could rely on audits by external bodies, actuarial reports, or – in the case of branches or foreign subsidiaries – on the opinion of other supervisors. However, where supervisors use external auditors or actuaries, they should consider:

– whether adequate controls over their competence exist, and the need to monitor their performance; and
– their independence towards the company and the consideration they give to the protection of the policy holders' interests.

Licence and registration in the register of commerce

63. Apart from applying for a supervisory licence, other requirements pertaining to trade and commercial law must in most cases be met (e.g. registration in the register of commerce). It depends on the jurisdiction if registration takes place before or after the licence is granted. However, companies should not be allowed to present themselves as licensed insurance companies without or before having been granted a licence.

Licensing body and supervisor

64. In some jurisdictions, not the supervisor, but a different body is responsible for granting licences (e.g. a ministry or a special council). If this is the case, the supervisor should have the authority to examine the documents submitted and give its opinion. If the supervisor's opinion is negative, the supervisor and the licensing body should agree before making a decision.

Duration of the licensing procedure

65. The supervisor should come to a decision as quickly as possible and not delay unduly. A certain period of time should be set from the date on which all licensing requirements are met. Within this period, the supervisor should decide on the application for a licence. However, if the supervisor has not come to a decision within this time, the licence cannot automatically be considered granted. The applicant company should have means at its disposal to obtain a decision within a reasonable time (e.g. by taking legal action).

Cooperation

66. The supervisor should be able to exchange information relevant for the application (e.g. check of suitability of directors and owners) with domestic or foreign authorities. However, the supervisor need not provide information where the information is not held confidential by the recipient.

VI. Withdrawal of licence

67. The supervisor should have at its disposal the remedial means of withdrawing the licence (possibly with respect to certain types of business). As a legal consequence of this withdrawal, the insurance company is no longer permitted to conclude new contracts, or prolong, or expand the cover of, existing contracts. Withdrawal of the licence should be possible under one of the following conditions:

a. the company no longer meets the licensing requirements;
b. the company seriously infringes the law in force,
c. the company expressly renounces the licence;
d. the company does not make use of the licence within a certain period of time, e.g. 12 months; or
e. the company has ceased to operate, e.g. at least six months ago.

68. Cases stated in paragraph 67a and 67b above apply for instance to situations in which the insurance company is no longer able to meet capital adequacy standards, or management meeting the fit and proper requirements can no longer be found. They also refer to cases in which the insurance company constantly contravenes orders from the supervisor that have legal force, or if it constantly infringes provisions under the contract law or the consumer protection law. The licence may also be withdrawn where the company is subsequently found to have furnished false, misleading or inaccurate information, or has concealed, or failed to disclose, material facts in its application for a licence. Due to the severe consequences which a withdrawal of the licence has also for existing contracts, it should only be used as the last resort where less stringent means, e.g. admonitions or orders from the supervisor or court decisions, have proven ineffective.

69. In cases stated in paragraph 68c-e above, the withdrawal of the licence creates a clear legal situation and improves transparency of the insurance market. It should be avoided that insurance companies apply for licences "just in case" without actually having the clear intention of operating insurance business. If an insurance company has either not taken up operations within quite a long period of time (e.g. over one year) or ceased operations, there is a certain risk that legal provisions or market conditions will have changed.

ANNEX Extract from "Insurance Supervisory Principles"

Licensing

Companies wishing to underwrite insurance in the domestic insurance market should be licensed. Where the insurance supervisor has authority to grant a license, the supervisor:

1. in granting a license, should assess the suitability of owners, directors, and/or senior management, and the soundness of the business plan, which could include pro forma financial statements, a capital plan and projected solvency margins; and
2. in permitting access to the domestic market, may choose to rely on the work carried out by an insurance supervisor in another jurisdiction if the prudential rules of the two jurisdictions are broadly equivalent.

Changes in Control

The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs. These may be the same as, or similar to, the requirements which apply in granting a license. In particular, the insurance supervisor should:

1. require the purchaser or the licensed insurance company to provide notification of the change in control and/or seek approval of the proposes change; and
2. establish criteria to assess the appropriateness of the change, which could include the assessment of the suitability of the new owners as well as any new directors and senior managers, and the soundness of any new business plan.

Supervisory Standard No.2

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON ON-SITE INSPECTIONS

October 1998

Supervisory Standard on On-site Inspections
IAIS Technical Committee

Contents

1. Introduction

1. The objective of insurance and reinsurance supervision is to protect policyholders and policy beneficiaries. To achieve this objective, Supervisory Authorities should elaborate supervision methods, which include the ability to conduct on-site inspections.

2. On-site inspection, whether by the supervisory authority or its representatives, is a vitally important part of the supervisory process, closely related to the on-going monitoring process. On the one hand, it provides information that supplements the analysis of the financial and statistical information sent by the insurance or reinsurance company. On the other hand, on-site inspection needs the support of market information and statistics deriving from the analysis of the annual accounts and returns.

3. On-site inspection is an important way to verify or capture reliable data and information in order to assess a company's current and prospective solvency, measuring its evolution and the reasons for this evolution.

4. But the usefulness of on-site supervision is not strictly limited to that point.

5. On-site inspection enables the supervisor to obtain information and detect problems that cannot be obtained or detected through on-going monitoring. In particular:

a. in the case of companies experiencing asset trouble, accounting irregularities or deficient management, it enables the supervisor to identify problems that the company could be given to ignore and, sometime, to hide;

b. it offers supervisors the opportunity to have a personal relationship with the managers, which is very valuable to assess their fitness and properness;

c. it enables supervisors to assess the management's decision-making processes and internal controls;

d. it can dissuade companies from pursuing activities, which are either illegal or improper;

e. it provides supervisors the opportunity to analyse the impact of specific regulations and, more generally, to gather information for benchmarking.

6. On-site inspection is also of great assistance in dealing with companies' problems. For example, the supervisors:

a. may be able to persuade the companies' management to take action to avoid current or future problems through dialogue during on-site inspection, which may be more efficient than through regulations;

b. can use on-site inspections as an opportunity to provide companies' management with information, especially concerning new legislation which might need to be explained in order to avoid misinterpretation.

7. The purpose of this paper is to provide insurance supervisors with some general supervisory standards for the conduct of on-site inspections. It is divided into three main parts:

a. most important objectives of on-site inspections;

b. description of the on-site inspection procedure;

c. organisation of the on-site inspection process.

2. Definitions

8. The following definitions apply to terms used in the paper:

Board of Directors refers to either the board of directors of a company which is incorporated in the jurisdiction or, in the case of a company which is incorporated in another jurisdiction and which is licensed in the jurisdiction, to a senior company official, acceptable to the insurance supervisor.

Financial Reports refer to accounting statements, financial returns and statutory reports, including the balance sheet and the income statement and any other numerical reports prepared for disclosure to policyholders, investors or insurance supervisors and do not refer to reports prepared for other purposes.

Insurance Company refers to a licensed legal entity, which underwrites insurance.

Insurance or Reinsurance Supervisor refers to the insurance supervisor in the jurisdiction.

Reinsurance Company refers to a legal entity, which underwrites only reinsurance.

3. Most Important Objectives of On-site Inspections

9. Generally speaking, the key objective of any on-site inspection is the appraisal of the company's current and prospective solvency. More specifically, the objective is to compare the risk profile of the company with its risk-carrying capacity and to detect any problem that may affect the company's capacity to meet its obligations towards policyholders in the long term.

10. However, on-site inspection should not be limited to detecting the company's problems. Supervisors should also delve into the reasons behind them and identify solutions to overcome them.

11. These objectives can be split into intermediate objectives:

a. to appraise the assets and liabilities (including off balance sheet commitments) and to analyse the adequacy of tariffs and the balance of operations;

b. to evaluate the technical conduct of the insurance business (e.g. actuarial methods, commercial policy, reinsurance policy);

c. to evaluate the treatment of customers and to determine whether unlawful or improper activities are engaged in at the expense of policyholders or public interests;

d. to assess the accounting and internal control systems, and to form an opinion on the corporate governance;

e. to detect problems that may arise from the company's organisation or its belonging to a group.

4. The On-site Inspection Procedure

4.1 Planning and preparation

12. Following the analysis of the financial and statistical information sent by the companies, the supervisor should develop a program, based upon a systematic analysis of the records of the company, for the on-site inspections which are to be carried out in the next months.

13. This plan will take into account on the average frequency of on-site inspections and the companies' risk profile. On-site inspections are more frequent and more in depth when they concern companies which are in a difficult economic or financial position. However, a major change in the top management or in the objectives and business plan of the company might be a sufficient reason for a new on-site inspection.

14. Nevertheless, the on-site inspection plan should remain indicative since new priorities might arise during the year. Besides, the length of the inspections is not predictable: the actual on-site inspection may take anything from one day to several months depending on the business of the company, its size, and above all on the problems met.

15. In this respect, an on-site inspection should begin with an overview of the company in order to properly plan and focus the fieldwork. This review should be pursued with the managers and result in an agenda of the fieldwork to be made.

4.2 Fieldwork

16. While on-going monitoring can be systematic and to a certain extent standardised (analysis of the consistency of financial statements, position of the company with respect to the average of the market), on-site inspection is customised and suited to the company's particulars, and to the problems detected on site. Thus, it is difficult to determine in advance the length and exact outlines of on-site inspections. Besides, an on-site inspection can either be a full-scale inspection or a partial one.

17. Where supervisors undertake a full-scale on-site inspection this one should include at least the activities listed below.

18. However, in case of an inspection concentrated on a limited area of specific concern, the supervisor could take into account only the relevant points among them. Besides, some of these activities can be conducted off site.

a. Evaluation of the management and internal control system

- reading of the minutes of the meetings of the Board of Directors, the auditors' reports and, if any, actuaries' and electronic data processing audits;
- analysis of the ownership structure and sources of capital funds;
- evaluation of the fitness and properness of the management, their efficiency, and their ability to acknowledge and correct their management mistakes (especially after changes in the composition of the board);
- examination of all the company's current internal procedures and risk control systems in order to assess the relevance of these internal controls and the company's approach to risk management;
- examination of the accounting procedures in order to know whether the financial and statistical information periodically sent to the supervisory authority is trustworthy or not, and in compliance with the regulations.

b. Analysis of the company's activity

- analysis of the major categories of business, the customers and the geographical spread thereof;

- examination of the business plans and meeting with the management to get information about the plans for the future;
- analysis of the contracts.

c. Evaluation of the technical conduct of insurance business

- evaluation of the organisation and the management of the company;
- analysis of the commercial policy of the company: in particular, policy conditions and commissions paid to the intermediaries;
- evaluation of the reinsurance cover and its security: in particular, the reinsurance cover should be appropriate to with the financial means of the company and the risks it covers.

d. Analysis of the relationships with external entities

- analysis of the organisational charts, the group structures and the intragroup links;
- analysis of the relationships with branches abroad and the intragroup transactions;
- analysis of agreements with external service providers;
- identification of any financial problems originating from any entity in the group to which the company belongs.

e. Evaluation of the company's financial strength

- analysis of the settlement of claims and the 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), the assets held to cover the technical provisions;
- verification of property and valuation of the company’s investments;
- analysis of the litigation and off balance sheet commitments;
- analysis of the forecasted balance sheets and profit & loss accounts of the next two or three years, on the basis of the most recent results and the management plans.

19. Where supervisors have the necessary powers to deal with the treatment of the customers, they may include the following points in the on-site inspection:

a. review of the information given to customers and checking of its sufficiency and adequacy;

b. review of the time for payment, the number and nature of litigation and the transactions with the policyholders;

c. assessment of the compliance with the consumer regulations.

4.3 Assessment and reporting

20. During, or at least at the end of this inspection, the supervisor should discuss findings with the insurance company and should pay adequate attention to its reaction.

21. Supervisors should follow up to ensure corrective action, when identified, has been acted upon.

5. Organisation of the On-site Inspection Process

22. On-site inspection should have a legal basis in order to sustain the right of the supervisor to obtain any information. Insurance legislation should give the Supervisory Authority wide-ranging powers to investigate insurance or reinsurance companies, and to gather any kind of information.

23. Furthermore, the supervisor should have the power, where appropriate, to extend on-site inspections to brokers and companies that have capital links with, or that have accepted functions outsourced by, the supervised company.

24. The Supervisory authorities should organise the process of on-site inspections in order to maximise their efficiency. By doing so, they should consider, among other matters, the allocation of supervisory tasks between supervisors and they may wish to outsource certain parts of the inspection.

25. Some supervisory organisations may have responsibility for both on-going monitoring and on-site inspections for a group of companies. This type of organisation provides close relation between the monitoring and on-site inspection. It also appears to be an efficient way to follow through companies during a long period of time. However, it needs officers dealing with all the aspects of insurance supervision (e.g. accounting, actuarial methods, finance, data processing) and all types of insurance (e.g. health, vehicle, liability).

26. Some supervisory organisations may have specialists in some tasks or in some types of insurance and take part in the on-site inspection of a great number of companies. This type of organisation appears to be flexible and efficient to deal with market problems. However, a good co-operation and exchange of information is needed between officers in charge of monitoring and those in charge of on-site inspection. Accordingly, results of analyses must be documented and accessible to both groups.

27. Whatever the internal organisation of the supervisory services, supervisors may get assistance from external auditors or actuaries to whom they delegate, in part or completely, on-site inspections. Using these professionals may provide the supervisory authorities with flexibility and augment their skill.

28. However, since supervisors remain responsible for the supervision, before using external auditors or actuaries, they should consider:

a. whether adequate controls over their competence exist and the need to monitor their performance (for instance, through reviewing their working papers);

b. their independence towards the company (in particular when they are paid by the Board of Directors) and the consideration they give to the protection of the policy holders' interests.

29. Besides, should such a delegation be set up, the supervisor should have the ability to take legal action against these auditors and actuaries, if necessary.

Supervisory Standard No.3

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON DERIVATIVES

October 1998

Supervisory Standard on Derivatives
Report from the Derivatives Sub-Committee
of the IAIS Technical Committee

The IAIS recognises that the supervisory approaches in member jurisdictions are evolving in response to developments in derivatives markets. This standard sets out risk management controls for insurers active in derivatives and a reporting framework that are applicable across the full range of potential activities. The IAIS encourages members to strive towards ensuring that the appropriate controls and reporting are in place for the insurers that they supervise taking into account the size, extent and complexity of the derivatives activity in their jurisdiction.

This standard provides guidance to supervisors in assessing how insurers control risks in derivatives. The approach chosen by individual supervisors will depend on the extent to which insurers are permitted to engage in derivatives activities, as well as on other factors such as the supervisor's legal authority, use of on-site and off-site supervisory techniques and the role of the external auditors. The supervisory approach will also be influenced by the extent to which the insurer uses derivatives and the purpose of their use.

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Background

1. A derivative is a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indexes (the "underlying asset"). Derivatives are financial contracts and include a wide assortment of instruments, such as forwards, futures, options, warrants, swaps and composites. This standard also applies to structured products that have the effect of derivatives and could apply to commodity derivatives, where insurers are permitted to engage in these transactions.

2. Insurers in a number of IAIS countries are permitted to use derivatives and these products can play a useful role in investment management. Insurers choosing to engage in derivative activities should clearly define their objectives, ensuring that these are consistent with any legislative restrictions.

3. The role of the insurer and the use of derivatives may be restricted for prudential reasons by legislation. For example, in many countries insurers may only be end users of derivatives and may not trade in derivatives on behalf of their clients. In a few jurisdictions, insurers are permitted to deal in derivatives, quoting bids and offers and committing capital to satisfy customer demands for derivatives.

4. Some jurisdictions may restrict the use of derivatives to the reduction of investment risk or efficient portfolio management, or may restrict the use of derivatives by the general investment rules relating to assets covering the technical provisions. Other jurisdictions allow a full range of use.

5. Derivative products have inherent risks that must be managed properly. As with traditional investment activities, insurance companies must address credit, market, liquidity, cashflow, operational and legal risks in their derivatives activities. The nature and the degree of these risks will depend on how derivatives are used. The growing complexity, diversity and volume of derivatives products, made possible by academic research and rapid advances in technology and communications, pose increasing challenges in managing these risks.

6. Supervisors in jurisdictions that permit insurers to engage in the full range of derivatives activities, including dealing and market making, should also refer to the guidance provided by the Basle Committee and IOSCO. [1]

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[1] Risk Management Guidelines for Derivatives, Basle Committee on Banking Supervision, July 1994.

Framework for supervisory information about the derivatives activities of banks and securities firms, Joint Report by the Basle Committee on Banking Supervision and the Technical Committee of the International Organisations of Securities Commissions, May 1995.

Risk Management Practices

Written Policies and Procedures

7. The primary components of a sound risk management process for derivatives include written policies and procedures that:

- clearly delineate lines of responsibility for managing risk;
- set in place adequate systems for measuring risk;
- create appropriately structured limits on risk taking;
- prescribe comprehensive and timely risk monitoring and reporting;
- establish effective independent internal controls; and
- are made known to all staff dealing with derivatives.

The process of risk management for derivatives activities should be integrated into the insurance company's overall risk management framework to the fullest extent possible.

Board of Directors

8. The Board of Directors should set the company's overall risk management strategy, including the purposes for which derivatives may be used. The Board should establish and approve an appropriate policy for the use of derivatives that is consistent with the objectives, strategy, and overall risk appetite of the insurance company. This should include lines of responsibility and a framework of accountability for derivatives functions. The policy should be communicated to all staff dealing with derivatives.

9. The Board of Directors should approve written internal guidelines relating to the types of derivatives to be used, the purposes and conditions of their use and the counterparties admissible. Approval should be based on:

- compliance with legal and regulatory restrictions;
- a full analysis of the risks, the objective of which is to ensure that the Board is fully aware of any adverse effects which could result from the use of derivatives. On a regular basis, the Board should receive reports on and evaluate the risk exposure of the organisation and should re-evaluate the risk management procedures and policies; and
- confirmation that remuneration policies are structured to avoid potential incentives for excessive risk taking and that remuneration for the back office and risk management functions is fully independent of investment results.

The Board of Directors should ensure that approved policies and procedures are in place before derivatives activities commence.

10. Derivative exposure should be considered in the context of the insurance company's overall asset/liability management strategy. In particular, derivative exposures combined with exposure to other financial instruments should not result in a net exposure which is inconsistent with the insurance company's investment strategy.

11. The variation in derivatives products is enormous. The Board of Directors should consider whether it is appropriate for the company to be involved in some types of derivatives. It may be appropriate to rule out or restrict the use of some types of derivatives where, for example:

- the potential exposure cannot be reliably measured;
- closing out of a derivative is difficult considering the illiquidity of the market;
- the derivative is not readily marketable as may be the case with over-the-counter instruments;
- independent (i.e. external) verification of pricing is not available; or
- the counterparty is not suitably creditworthy.

12. The Board should consider setting exposure limits for derivatives taking account of the purpose of their use and the uncertainty caused by credit, market, liquidity, cashflow, operations and legal risk. Serious consideration should be given to having quantitative limits for the exposure to any one counterparty (taking account of the credit risk of the counterparty) particularly in relation to "over-the-counter" transactions.

13. Exposure limits for derivatives must be integrated into the overall limits set out in the insurance company's investment strategy. Risk exposures should be calculated on the company's total on and off balance sheet position. For example, in evaluating credit risk the Board of Directors should take into account all accumulated credit risks to which the insurer is exposed, whether they originate from derivatives, securities, reinsurance or other transactions.

14. The Board should ensure that the company has an appropriate capability to independently verify pricing when "over-the-counter" derivatives are used.

15. The Board must ensure that the reporting and internal control systems of the insurer are designed to monitor that derivatives are being used in accordance with the stated objectives and strategy and legal and regulatory requirements. The Board must ensure that:

- they receive regular information on risk exposure and derivatives usage in a form which is understood by them and which permits them to make an informed judgement as to the level of risk on a mark-to-market basis;
- the systems provide accurate and timely information on risk exposure and derivatives positions and are capable of responding to ad hoc requests;
- they approve the internal control procedures relating to derivatives activities; and
- the internal controls include an adequate segregation of the functions responsible for measuring, monitoring and controlling derivatives activities from those conducting day to day derivatives transactions.

16. The Board of Directors should ensure that collectively they have sufficient expertise to understand the important issues related to derivatives and that all individuals conducting and monitoring derivatives activities have sufficient levels of knowledge and experience.

Senior Management

17. Senior management should establish clear written operational policies and procedures for implementing the derivatives policy set by the Board. Their responsibility includes specifying lines of responsibility for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls and a comprehensive risk-reporting process.

18. The content of operational policies and procedures will be different for each insurance company but the level of detail should be consistent with the complexity and volume of derivative usage and the strategy and objectives of the insurer. They should include, as appropriate:

- the purpose for which particular derivatives are to be used, including the circumstances in which derivatives transactions can be used and acceptable rationales for undertaking transactions;
- procedures for seeking approval for the usage of new types of derivatives: these should include addressing the extent to which there will be any trading activity and who should take decisions in this regard;
- procedures for the approval of counterparties and brokers;
- details of who is authorised to enter into derivatives transactions;
- procedures by which senior management exercises control over derivatives activities;
- the quantitative limits to the use of each type of derivative;
- the quantitative limits to credit, market and other risks;
- procedures for monitoring liquidity risk;
- internal procedures covering front office, back office, measurement of compliance with counterparty credit lines and limits, control and reporting;
- valuation procedures for risk management purposes on a mark-to-market basis or equivalent for over the counter transactions; and
- the identification of who should be responsible for the valuation. Valuations should be carried out by individuals independent of those responsible for trade execution or, if this is not possible, valuations should be independently checked or audited on a timely basis.

Accounting and taxation rules should also be taken into consideration in developing operational policies and procedures for the use of derivatives.

19. Senior management should allocate sufficient resources to establish and maintain sound and effective risk management systems. These systems should be integrated with the front office, back office, accounting and reporting systems.

20. At least annually, senior management should review the adequacy of its written operational policies and procedures in light of the insurance company's activities and market conditions. The Board of Directors must approve changes to derivatives policies and procedures or reaffirm the existing policies.

Risk Management

21. A formal organisational structure should be established to monitor and manage the risks inherent in any investment activity undertaken by the insurance company. Risks arising from derivatives activities (market, credit, liquidity, cashflow, operational and legal risk) should be monitored and managed in an integrated manner with the similar risks arising from non-derivatives activities so that senior management can regularly assess risk exposures on a consolidated basis.

22. The overall risk management function should allocate resources to measuring risks specific to derivatives activities, comparing them against pre-determined risk limits and reporting to senior management. Therefore the responsibilities of the risk management function should include:

- setting detailed limits for each major type of risk involved in the insurer's derivatives activities, as appropriate. These limits should be consistent with the company's overall risk management process and with the adequacy of its capital position;
- formally noting and promptly reporting breaches;
- reviewing risk management activity over the past period; and
- monitoring compliance with the approved overall risk management strategy, counterparty credit lines, and limits.

23. Systems for measuring the various risks arising from derivatives activities should be comprehensive and accurate, such that risk can be measured and aggregated across trading and non-trading activities on an organisation-wide basis and, as appropriate, on a group-wide basis, at any given time. These systems will vary from company to company, however they should be:

- sufficiently robust to reflect the scale of the risks and the activity undertaken;
- capable of accurately capturing and measuring all significant risks in a timely manner; and
- understood by all relevant personnel at all levels of the insurer.

24. Once risk management policies and limits have been put in place, adequate procedures should be established for monitoring compliance with those policies and limits. These procedures should assist prevention and enable the early detection of non-compliance with the risk management policies. In many cases this will involve some form of daily monitoring.

25. The risk management function should assess the robustness of the risk policies and limits. To do this, regular stress testing should be undertaken for a wide range of market scenarios and changing investment and operating conditions. Once an insurer has identified those situations to which it is most at risk, it should ensure that it puts in place appropriate policies and procedures to manage them effectively.

26. The risk management function should regularly report to appropriate levels of senior management and to the Board of Directors. The frequency of reporting should provide these individuals with adequate information to judge the changing nature of the insurer's risk profile. The reports should indicate how the derivatives activities are meeting the stated objectives and complying with approved policies and procedures.

Internal Controls

27. All individuals conducting, monitoring, controlling and auditing derivatives business should be suitably qualified and should have appropriate levels of knowledge and experience.

28. Adequate systems of internal control must be present to ensure that derivatives activities are properly supervised and that transactions have been entered into only in accordance with the insurer's authorised policies and procedures. The extent and nature of internal controls adopted by each insurer will be different, but procedures to be considered should include:

- reconciliations between the front office, back office and accounting systems, to be carried out at an appropriate level depending on the extent of derivatives activity (as a guide, insurers which actively use derivatives should carry out reconciliations daily);
- procedures to ensure that any restrictions on the power of all parties to enter into any particular derivatives transaction are observed. This will require close and regular communication with those responsible for compliance, legal and documentation issues in the insurer;
- procedures to ensure all parties to the transaction agree with the terms of the deal. Procedures for promptly sending, receiving and matching confirmations should be independent of the front office function;
- procedures to ensure that formal documentation is completed promptly;
- procedures to ensure reconciliation of positions reported by brokers;
- procedures to ensure that positions are properly settled and reported, and that late payments or late receipts are identified;
- procedures to ensure that all authority and dealing limits are not exceeded and all breaches can be immediately identified;
- procedures to ensure the independent checking of rates or prices; and
- procedures to monitor any derivative transaction which requires specific action (such as exercise of an option) or which contemplates delivery of an underlying asset so as to ensure that the transaction will either be closed out or that the insurer will be in a position to make or take delivery.

29. Regular and timely reports of derivatives activity should be produced which describe the company's exposure in clearly understandable terms and include quantitative and qualitative information. The reports should, in principle, be produced on a daily basis for senior management purposes; less frequent reporting may be acceptable depending on the nature and extent of derivatives activities . Upward reporting to the Board of Directors is recommended on at least a monthly basis. Reports should cover the following areas:

- commentary on derivative activity in the period and the relevant period end position;
- details of positions by type of product;
- an analysis of credit exposures by counterparty;
- details of any regulatory or internal limits breached in the period and the actions taken thereto; and
- planned future activity.

30. The functions responsible for measuring, monitoring, settling and controlling derivatives transactions should be distinct from the front office functions. These functions should be adequately resourced.

31. Where external asset managers are used, the Board of Directors must ensure that senior management is in a position to monitor the performance of those managers against Board approved policies and procedures. The insurer must retain appropriate expertise and ensure that, under the terms of the contract, it receives sufficient information to evaluate the compliance of the asset manager with the investment mandate.

Internal Audits

32. Insurance companies should have an internal audit program that includes coverage of their derivatives activities and ensures timely identification of internal control weaknesses and operating system deficiencies. The internal audit function must be independent of the functions and controls it inspects. Concerns with regard to derivatives activities should be reported to senior management and the Board.

33. Internal audit coverage should be provided by competent professionals who are knowledgeable of the risks inherent in derivatives.

34. Internal auditors should be expected to evaluate the independence and overall effectiveness of the institution's risk management functions. In this regard, they should thoroughly evaluate the effectiveness of the internal controls relevant to measuring, reporting and limiting risks. Internal auditors should evaluate compliance with risk limits and the reliability and timeliness of information reported to senior management and the Board of Directors.

35. Internal auditors should also periodically review derivatives operations to ensure compliance with the insurance company's regulatory obligations.

Supervision

36. In monitoring the activities of insurance companies involved in derivatives, supervisors must satisfy themselves that companies have the ability to measure, analyse and manage the associated risks. In order to achieve this objective supervisors should see to it that companies have appropriate quantitative and qualitative information on their derivatives activities. Information required by supervisors should reflect the extent of derivatives activities.

37. Supervisors should obtain sufficient information on the company's written policies and procedures on derivatives and may wish to request the following information:

- the purpose for which particular derivatives are to be used and acceptable rationales for undertaking transactions;
- procedures for the approval of counterparties and brokers;
- procedures for seeking approval to use new types of derivatives;
- the limits to credit, market, and other risks;
- procedures for monitoring liquidity risk;
- internal procedures covering front and back office functions, measurement of compliance with counterparty credit lines and limits, oversight, control and reporting;
- the professional qualifications of those entrusted with derivatives activities;
- the valuation methodology; and
- compliance reports.

38. Periodically supervisors should monitor the extent of an insurer's exposure in derivatives. Supervisors may wish to obtain some or all of the following quantitative information:

- notional amounts of derivatives by broad risk category, instrument type and trading type (over-the-counter or exchange-traded) in order to understand the scope and nature of the insurance company's involvement in derivatives activities;
- market values of derivatives, or equivalent for over the counter instruments, by broad risk category, instrument type and trading type in order to gauge the insurer's exposure to financial risk;
- for derivatives used in relation to the management of invested assets or liabilities, the net value of the related positions; and
- where derivatives are held for purposes other than the management of the portfolio of assets, additional information, as appropriate, using the common minimum reporting framework developed by the Basle Committee and IOSCO as an example.

Information may include the end-of-period position, the average position and the maximum position over the analysis period.

39. This information should be accessible to supervisors through on-site examinations, external audits, discussions with companies, special surveys, as well as regular reporting procedures. Supervisors may wish to make use of internal management information on derivatives. Information should be timely and comprehensive (i.e., it should include all types of derivative transactions and cover the entire reporting entity). In cases where insurers outsource certain functions, they are still responsible for ensuring that information is available for supervisory purposes.

Public Disclosure of Information

40. Supervisors should consider requiring that insurers provide qualitative and quantitative information on derivative activities to the public. Some jurisdictions encourage public disclosure and increased transparency as a form of market discipline.

Glossary

Cashflow risk:	the risk that the entity will not be able to finance its derivatives activities (for example, meeting margin calls on futures contracts.)
Composite:	a combination of two or more standard derivatives to achieve a specified objective.
Counterparty:	the other party with whom a derivatives contract is made.
Credit risk:	the risk that a counterparty will not pay an amount due as called for in the original agreement, and may eventually default on an obligation.
Liquidity risk:	the risk that the entity may not be able to, or cannot easily, unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the market place.
Market risk:	is the risk to an institution's financial condition resulting from adverse movements in stocks, bonds, interest rates, exchanges rates, commodity prices and so on.
Operational risk:	the risk that deficiencies in information systems or internal controls will result in unexpected loss. This risk is associated with human error, system failures and inadequate procedures and controls. This risk can be exacerbated in the case of certain derivatives because of the complex nature of their payment structures and calculation of their values.

Supervisory Standard No. 4

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON ASSET MANAGEMENT BY INSURANCE COMPANIES

December 1999

Supervisory Standard on Asset Management by Insurance Companies

Contents

1. Preamble

1. The nature of the insurance business implies the formation of technical provisions, and investment in and the holding of assets to cover these technical provisions and a solvency margin. In order to ensure that an insurer can meet its contractual liabilities to policyholders, such assets must be managed in a sound and prudent manner taking account of the profile of the liabilities held by the company and, indeed, the complete risk-return profile. The complete risk-return profile should result from an integrated view on product and underwriting policy, reinsurance policy, investment policy and solvency level policy. The liabilities profile of a company with respect to term, and the predictability of the size and timing of claims payments, may differ significantly according to the nature of the insurance business conducted. It thus follows that the need, for example, to maintain a high degree of liquidity within the asset portfolio will similarly differ between insurers. Differences in the accounting and taxation treatment of the various types of insurance business may also influence investment decisions.

2. This standard builds on the framework set out in the IAIS paper "Insurance Supervisory Principles" approved in September 1997. Its objective is to describe the essential elements of a sound asset management system and reporting framework across the full range of investment activities. The standard thus provides guidelines for good practice for supervisors to use as a checklist in assessing how insurers should control the risks associated with their investment activities. Given the wide variation in the nature of companies, it is

acknowledged that the extent of the application of the practices described in the standard by any given insurer may differ according to the size and structure of an insurance company and the type of business it conducts. However, the basic principles of Board of Directors' responsibility, the need for an investment policy, segregation of duties and control will be applicable to all insurance companies. Similarly, the exact approach adopted by individual supervisors for the assessment of asset management systems will need to take into account local statutory restrictions with respect to the investment policies and procedures of insurers, and other factors such as supervisors' legal authority, use of on-site and off-site supervisory techniques, and the role of the actuary and the external auditors.

3. Supervisors in jurisdictions that permit insurers to use derivative instruments as part of their portfolio management processes or to hold structured products that have the effect of derivatives should also refer to the specific IAIS Supervisory Standard on Derivatives.

2. Introduction

2.1 Asset Liability Management

4. A key driver of the asset strategy adopted by an insurer will be its liabilities profile, and the need to ensure that it holds sufficient assets of appropriate nature, term and liquidity to enable it to meet those liabilities as they become due. Detailed analysis and management of this asset/liability relationship will therefore be a pre-requisite to the development and review of investment policies and procedures which seek to ensure that the insurer adequately manages the investment-related risks to its solvency. The analysis will involve, inter alia, the testing of the resilience of the asset portfolio to a range of market scenarios and investment conditions, and the impact on the insurer's solvency position.

2.2 The Investment Process

5. Depending upon the nature of their liabilities insurers will typically hold, in varying proportions, four main types of financial assets either directly, via other investment vehicles (such as UCITS [Undertakings for Collective Investments in Transferable Securities]), or through third party investment managers:

a. Bonds and other fixed income instruments;

b. Equities and equity type investments;

c. Debts, deposits and other rights;

d. Property.

6. The holding of a given asset portfolio carries a range of investment-related risks to technical provisions and solvency which insurers need to monitor, measure, report and control. The main risks are market risk (adverse movements in, for example, stocks, bonds

and exchange rates), credit risk (counterparty failure), liquidity risk (inability to unwind a position at or near market price), operational risk (system/internal control failure), and legal risk.

7. The actual composition of an asset portfolio at any given moment should be the product of a well-structured investment process itself, which for the purposes of this standard is regarded as a circular movement characterised by the following steps:

a. Formulation and development of a strategic and tactical investment policy;

b. Implementation of the investment policy, in a suitably equipped investment organisation, and on the basis of a clear and precise investment mandate(s);

c. Control, measurement and analysis of the investment results which have been achieved and the risks taken;

d. Feedback to the appropriate level of authority on points a, b and c.

8. Jurisdictions could adopt the approach of imposing legislative restraints on the investment policies and procedures of insurers by placing restrictions on the type of, and extent to which, certain asset classes may be used to cover technical provisions, and/or specific requirements on the matching of assets and liabilities. Some jurisdictions may prefer qualitative demands. Whatever the approach, insurers should develop and operate overall asset management strategies, which take account of the need to ensure the existence of:

a. The definition of a strategic investment policy by the Board of Directors, based on an assessment of the risks incurred by the company and its risk appetite;

b. On-going Board and senior management oversight of, and clear management accountability for, investment activities;

c. Comprehensive, accurate and flexible systems which allow the identification, measurement and assessment of investment risks, and the aggregation of those risks at various levels, for example for any separate portfolios held, for the insurance company and, as appropriate, at group level, at any given time. Such systems will vary from company to company, but should be:

- sufficiently robust to reflect the scale of the risks and the investment activity undertaken;
- capable of accurately capturing and measuring all significant risks in a timely manner;
- understood by all relevant personnel at all levels of the insurer;

d. Key control structures, such as the segregation of duties, approvals, verifications, reconciliations;

e. Adequate procedures for the measurement and assessment of investment performance;

f. Adequate and timely communication of information on investment activities between all levels within the insurance company;

g. Internal procedures to review the appropriateness of the investment policies and procedures in place;

h. Rigorous and effective audit procedures and monitoring activities to identify and report weaknesses in investment controls and compliance.

i. Procedures to identify and control the dependence on and vulnerability of the insurer to key personnel and systems.

9. The following sections further develop the above principles, recognising that less formalised structures and procedures than those described herein may be applicable depending on the size and nature of the business of an individual insurer.

3. Definition of the Investment Policy and Procedures

3.1 Board of Directors

10. The Board of Directors should be responsible for the formulation and approval of the strategic investment policy, taking account of the analysis of the asset/liability relationship, the insurer's overall risk tolerance, its long-term risk-return requirements, its liquidity requirements and its solvency position.

11. The investment policy, which should be communicated to all staff involved in investment activities, should in principle address the following main elements:

a. The determination of the strategic asset allocation, that is, the long-term asset mix over the main investment categories;

b. The establishment of limits for the allocation of assets by geographical area, markets, sectors, counterparties and currency;

c. The formulation of an overall policy on the selection of individual securities and other investment titles;

d. The adoption of passive or more active investment management in relation to each level of decision making;

e. In the case of active management, definition of the scope for investment flexibility, usually through the setting of quantitative asset exposure limits.

f. The extent to which the holding of some types of assets is ruled out or restricted where, for example, the disposal of the asset could be difficult due to the illiquidity of the market or where independent (i.e. external) verification of pricing is not available;

g. An overall policy on the use of financial derivatives as part of the general portfolio management process or of structured products that have the economic effect of derivatives;

h. The framework of accountability for all asset transactions.

12. The Board of Directors should also be responsible for establishing policies on related issues of a more operational nature, including:

a. The choice between internal or external investment management, and, for the latter, the criteria for selection of the manager(s). Also, in case of external management, a choice usually needs to be made between having a segregated (discretionary) portfolio managed, or participating in a collective or pooled fund, or other indirect investment vehicles;

b. The selection and use of brokers;

c. The nature of custodial arrangements;

d. The methodology and frequency of the performance measurement and analysis.

13. The Board of Directors should authorise senior management to implement the overall investment policy. The Board of Directors must, however, always retain ultimate responsibility for the company's investment policy and procedures, regardless of the extent to which associated activities and functions are delegated or, indeed, outsourced.

14. As part of the development of the asset management strategy the Board of Directors must also ensure that adequate reporting and internal control systems of the insurer are in place, and designed to monitor that assets are being managed in accordance with the investment policy and mandate(s), and legal and regulatory requirements. The Board of Directors must ensure that:

a. They receive regular information, including feedback from the company's risk management function, on asset exposures, and the associated risks, in a form which is understood by them and which permits them to make an informed judgement as to the level of risk on a mark-to-market basis;

b. The systems provide accurate and timely information on asset risk exposure and are capable of responding to ad hoc requests;

c. The internal controls include an adequate segregation of the functions responsible for measuring, monitoring and controlling investment activities from those conducting day to day asset transactions;

d. Remuneration policies are structured to avoid potential incentives for unauthorised risk taking.

15. Where external asset managers are used, the Board of Directors must ensure that senior management is in a position to monitor the performance of the external managers

against Board approved policies and procedures. External managers should be engaged under a contract that, inter alia, sets out the policies, procedures and quantitative limits of the investment mandate. The insurer must retain appropriate expertise and ensure that, under the terms of the contract, it regularly receives sufficient information to evaluate the compliance of the external asset manager with the investment mandate.

16. The Board of Directors should collectively have sufficient expertise to understand the important issues related to investment policy and should ensure that all individuals conducting and monitoring investment activities have sufficient levels of knowledge and experience.

17. At least annually, the Board of Directors should review the adequacy of its overall investment policy in the light of the insurance company's activities, and its overall risk tolerance, long-term risk-return requirements and solvency position.

3.2 Senior Management

18. The responsibility for the preparation of a written investment mandate(s) setting out the operational policies and procedures for implementing the overall investment policy established by the Board of Directors will frequently be delegated to senior management. The precise content of the mandate will be different for each insurance company but the level of detail should be consistent with the nature of any regulatory constraint and complexity and volume of investment activity, and should specify as appropriate:

a. The investment objective, and the relevant limits for asset allocation, and the currency allocation and policy; any relevant investment benchmarks should also be specified;

b. An exhaustive list of permissible investments and, as appropriate, derivative instruments, including details of any restrictions as to markets (e.g. only securities listed at specified stock exchanges), minimum rating requirements or minimum market capitalisation, minimum sizes of issues to be invested in, diversification limits and related quantitative or qualitative limits;

c. Details of whom is authorised to undertake asset transactions;

d. Any other restrictions with which portfolio managers have to comply, for example maximum risk limits within the overall investment policy (or in terms of limits on the duration of the portfolio in the case of a fixed-income portfolio), authorised counterparties;

e. The agreed form and frequency of reporting and accountability.

19. Supporting internal management procedures should be documented and include:

a. Procedures for seeking approval for the usage of new types of investment instruments: the desirability of retaining the flexibility to utilise new investment instruments should be balanced with the need to identify the risks inherent in them and ensure that they will be subject to adequate controls before approval is given for their acquisition. The

principles for measuring such risk, and the methods of accounting for the new investments should be clarified in detail prior to approval being given for their acquisition;

b. Procedures for the selection and approval of new counterparties and brokers;

c. Procedures covering front office, back office, measurement of compliance with quantitative limits, control and reporting;

d. Details of the action which will be taken by senior management in cases of non-compliance;

e. Valuation procedures for risk management purposes;

f. Identification of who should be responsible for the valuation. Valuations should be carried out by individuals independent of those responsible for trade execution or, if this is not possible, valuations should be independently checked or audited on a timely basis.

Accounting and taxation rules should be taken into consideration in developing the above operational policies and procedures.

20. Senior management should ensure that all individuals conducting, monitoring and controlling investment activities are suitably qualified and have appropriate levels of knowledge and experience.

21. At least annually, senior management should review the adequacy of its written operational procedures and allocated resources in the light of the insurance company's activities and market conditions.

4. Monitoring and Control

4.1 Risk Management Function

22. Insurers should be capable of identifying, monitoring, measuring, reporting and controlling the risks connected with investment activities. This process should be performed by a risk management function with responsibility for:

a. Monitoring compliance with the approved investment policy;

b. Formally noting and promptly reporting breaches;

c. Reviewing asset risk management activity and results over the past period;

d. Reviewing the asset/liability and liquidity position.

23. The risk management function should also assess the appropriateness of the asset allocation limits. To do this, regular resilience testing should be undertaken for a wide range of market scenarios and changing investment and operating conditions. Once an insurer has identified those situations to which it is most at risk, it should ensure that it feeds back appropriate amendments to the policies and procedures defined in its investment mandate in order to manage those risk situations effectively.

24. The risk management function should regularly report to appropriate levels of senior management and, as appropriate, to the Board of Directors. The reports should provide aggregate information as well as sufficient detail to enable management to assess the sensitivity of the company to changes in market conditions and other risk factors. The frequency of reporting should provide these individuals with adequate information to judge the changing nature of the insurer's asset profile, the risks that stem from it and the consequences for the company's solvency.

4.2 Internal Controls

25. Adequate systems of internal control must be present to ensure that investment activities are properly supervised and that transactions have been entered into only in accordance with the insurer's approved policies and procedures. Internal control procedures should be documented. The extent and nature of internal controls adopted by each insurer will be different, but procedures to be considered should include:

a. Reconciliations between front office and back office and accounting systems;

b. Procedures to ensure that any restrictions on the power of all parties to enter into any particular asset transaction are observed. This will require close and regular communication with those responsible for compliance, legal and documentation issues in the insurer;

c. Procedures to ensure all parties to the asset transaction agree with the terms of the deal. Procedures for promptly sending, receiving and matching confirmations should be independent of the front office function;

d. Procedures to ensure that formal documentation is completed promptly;

e. Procedures to ensure reconciliation of positions reported by brokers;

f. Procedures to ensure that positions are properly settled and reported, and that late payments or late receipts are identified;

g. Procedures to ensure asset transactions are carried out in conformity with prevailing market terms and conditions;

h. Procedures to ensure that all authority and dealing limits are not exceeded and all breaches can be immediately identified;

i. Procedures to ensure the independent checking of rates or prices: the systems should not solely rely on dealers for rate/price information.

26. The functions responsible for measuring, monitoring, settling and controlling asset transactions should be distinct from the front office functions. These functions should be adequately resourced.

27. Regular and timely reports of investment activity should be produced which describe the company's exposure in clearly understandable terms and include quantitative and qualitative information. The reports should, in principle, be produced on a daily basis for senior management purposes; less frequent reporting may be acceptable depending on the nature and extent of asset transactions. Upward reporting by senior management is recommended on at least a monthly basis. Reports should at least include the following areas:

a. Details of, and commentary on, investment activity in the period and the relevant period end position;

b. Details of positions by asset type;

c. An analysis of credit exposures by counterparty;

d. Details of any regulatory or internal limits breached in the period and the actions taken thereto;

e. Planned future activity;

f. Details of the relative position of assets and liabilities.

4.3 Audit

28. Insurance companies should have an audit that includes full coverage of their investment activities and ensures timely identification of internal control weaknesses and operating system deficiencies. If the audit is performed internally it must be independent. Concerns with regards to investment activity must be reported to senior management and the Board of Directors.

29. Audit coverage should be provided by competent professionals who are knowledgeable of the risks inherent in all assets held.

30. Auditors should be expected to evaluate the independence and overall effectiveness of the insurer's asset management functions. In this regard, they should thoroughly evaluate the effectiveness of the internal controls relevant to measuring, reporting and limiting risks. Auditors should evaluate compliance with risk limits and the reliability and timeliness of information reported to senior management and the Board of Directors.

31. Auditors should also periodically review the insurer's asset portfolio and written investment policies and procedures to ensure compliance with the insurance company's regulatory obligations.

5. Supervision

32. In monitoring the asset management of insurance companies, supervisors must satisfy themselves that companies have the ability to identify, monitor, measure, report and control the associated risks. In order to achieve this objective supervisors should require that insurers have in place an overall investment policy and procedures approved by the Board of Directors, including procedures that ascertain that the Board receive appropriate quantitative and qualitative information on the investment activities and asset positions. Supervisors may also wish to satisfy themselves that companies have in place effective procedures for monitoring and managing their asset/liability position to ensure that their investment activities and asset positions are appropriate to their liabilities profiles.

33. In order to assess how insurers control the risks associated with their investment activities, supervisors may periodically request the following information:

a. A description of the Board of Directors' overall approach and policy on products and underwriting, reinsurance, investment and solvency;

b. Asset/liability management procedures;

c. Specific details of the investment policy, and monitoring and control procedures including:

- the asset classes approved by the Board of Directors for use by the company and details of portfolio composition;
- procedures for the approval of counterparties;
- procedures for seeking approval to use new investment instruments and for ensuring that asset risk controls, once established, keep pace with the emergence of new investment instruments;
- procedures covering front and back office functions, measurement of compliance with any limits, oversight, control and reporting;
- the limits to credit, market, and other risks;
- procedures for monitoring liquidity risk;
- the professional qualifications of those entrusted with investment activities;
- the valuation methodologies;
- compliance reports;
- the procedures for selecting and monitoring any external asset managers used;
- the risk position of the asset portfolio, using, for example, value at risk calculations or other methodologies.

34. This information should be accessible to supervisors through on-site inspections, external audits, discussions with companies, special surveys, as well as regular reporting procedures. Supervisors may make use of internal management information on asset portfolios. Information should be timely and comprehensive (i.e. it should include all assets

held and cover the entire reporting entity). In cases where insurers outsource all or part of their asset management, they should still be responsible for ensuring the availability of information for supervisory purposes.

Supervisory Standard No. 5

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON GROUP COORDINATION

October 2000

Supervisory Standard on Group Coordination
Report from the IAIS Technical Committee

Contents

1. Background

1. Internationally operating financial groups (including insurance groups) are important and indispensable participants in financial markets worldwide. Prudential supervisors need to address prudential issues arising from the activities of international financial groups.

2. The IAIS has issued several papers setting out principles, standards and guidance notes relating to the supervision of insurers and insurance groups, including: 'Principles Applicable to the Supervision of International Insurers and Insurance Groups and Their Cross-Border Establishments' (approved Sydney, September 1997).[1]

3. Given the importance and complexity of international financial groups, the IAIS seeks to extend its work on international insurance groups and other international financial groups which are significantly involved in insurance activities.[2]

4. The Technical Committees of the IAIS and IOSCO and the Basel Committee have endorsed the Joint Forum Principles papers dealing with supervision of international financial conglomerates (February 1999).[3] That guidance is intended primarily for the supervisors of diversified financial firms with complex organisational and management structures whose activities cross national borders

[1] Cf. IAIS, Insurance Principles, Standards and Guidance Papers, Basel 1998, pp 11-17. A revised paper is sent out for consultation by the IAIS Technical Committee (summer of 1999).
[2] By 'significant' is meant such a degree of insurance activities that seen from an insurance policy holders' perspective the role of insurance supervision is indispensable.
[3] Joint Forum Coordinator Paper in: Joint Forum, Supervision of Financial Conglomerates, Basel 1999, pp. 111-119.

and sectoral boundaries. The Technical Committee of IAIS has decided to build upon the principles relating to coordination and information-sharing between supervisors with respect to international insurance groups and other international financial groups which are significantly involved in insurance activities. Although this paper is directed primarily to insurance supervisors, other supervisors may benefit from the application of principles and processes hereinafter set out.

2. Introduction and Preliminaries

5. There are a number of different kinds of financial groups, ranging from national homogeneous groups to international heterogeneous financial conglomerates.

6. Insurance and other financial groups embody financial institutions involved in both retail and wholesale markets. Governments recognise the need for, and have facilitated, the establishment of systems of prudential regulation of the financial sector for several reasons, including a well functioning and stable economy and the protection of consumers.

7. In recent years, the financial markets in many countries of the world have experienced a substantial concentration process that has led to the emergence of larger and more complex financial groups. The reach of many such groups crosses national borders.

8. Coordination issues between supervisors/regulators in home and host countries were addressed by the IAIS in: 'Principles Applicable to the Supervision of International Insurers and Insurance Groups and Their Cross-Border Establishments'.[4] However, the prominence of international financial groups with significant insurance activities raises additional supervisory questions. In particular:

a. Does the traditional solo-supervision of separate licensed financial institutions (operating in groups) need to be supplemented with a form of group wide prudential supervision, and, if so, in what way?

b. Should a global coordination take place of the activities of the various supervisors involved with a specific financial group, and if so, in what way?

9. The answers will depend on several factors, such as the degree of internationalisation, the extent of heterogeneity, the legal and management structure of the group and the regulatory framework in place. For example, for an insurance group with the main company in one country and a handful of subsidiaries in various other countries the response is likely to be negative. On the other hand, for an international financial group with extensive insurance operations and regulated entities in several countries responses are likely to be positive.

10. This paper pertains to international insurance groups and other international financial groups which are significantly involved in insurance activities where a kind of group comprehensive

[4] See note 1.

supervision may usefully supplement the solo-supervision of the licensed entities. It addresses the coordination of supervisory activities with respect to the regulated entities within such groups.

11. The IAIS recognises that member countries have legal and supervisory structures which need to be taken into account in developing and modelling coordination and information sharing arrangements based on the standards enumerated in section V. This also applies to the endorsed IAIS Principles and Joint Forum Principles. The standards should not hamper supervisory authorities in finding adequate and effective solutions for specific situations and for new unforeseen developments. The standards should be applied with the flexibility that prudential practice demands.

12. Cooperation between supervisors implies the exchange of prudential information in a fruitful and efficient process. It therefore is appropriate to refer to the IAIS document 'A Model Memorandum of Understanding'.[5] Furthermore, the importance of a satisfactory regulation of the secrecy of exchanged prudential information has been underlined earlier by the IAIS.[6]

13. Although cooperation between supervisors is indispensable in emergency cases, coordination arrangements and procedures of information exchange should be discussed and a process agreed to before problems emerge. The discussion of coordination arrangements and ongoing contacts between supervisors will create a climate of trust and provide a foundation that will facilitate coordination during emergency situations.

3. Definitions

Financial institution refers to a legal entity which is predominantly involved in financial activities.

Licensed financial institution refers to a financial institution which has received a permit from a regulator or a supervisor to do specific financial business as defined by that particular licence (e.g. life assurance, non-life insurance, banking etc.).

Insurer (insurance company) refers to a licensed legal entity which underwrites (direct) insurance.

Financial group refers to an economic group structure of which the constituent entities are predominantly involved in (licensed) financial activities.

Insurance group refers to a financial group that consists of two or more insurers (and possibly other non-licensed entities).[7,8]

[5] See IAIS, Insurance principles Standards and Guidance Papers, Basel 1998, pp. 71-80.

[6] See e.g. the IAIS publication in note 1, paragraphs 18 and 19. See also Joint Forum on Financial Conglomerates, Principles for Supervisory Information Sharing paper, Basel 1999, pp. 100-107.

[7] This was already the definition of the Tripartite Group, which was subsequently adopted by the Joint Forum.

[8] The use of more than the three already mentioned financial sectors, e.g. investment funds, building societies or pension funds, requires a more general and wider definition of a financial conglomerate.

Financial conglomerate is defined as any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance). ,

International financial conglomerate refers to a financial conglomerate with regulated entities located in different countries.

Homogeneous financial group means an economic group,[9] consisting of (predominantly) financial licensed entities which essentially have the same sectoral character, e.g. a group consisting of life and/or non-life insurance companies.

Heterogeneous financial group means an economic group with a mixed character, consisting of different financial entities, such as banks, insurance companies, securities houses, investment firms, pension funds, etc.

(Small) Coordination committee refers to a (small) group of supervisors which are responsible for the development and the implementation of a coordination arrangement for a specific group.

Key-coordinator (lead supervisor) is the supervisor who is responsible for the coordination of the group comprehensive supervisory arrangement for a specific group.

Solo supervision refers to the supervision of a licensed financial entity by the supervisor in the jurisdiction where the licensed financial entity is incorporated, whereby the supervised entity is treated as a 'stand-alone' entity. The solvency requirements are applied on a stand-alone basis.

Group wide supervision refers to a supervisory approach to a financial group which considers the group structure, the constituent licensed entities and all the interrelationships within that financial group.[10]

Consolidated supervision refers to a supervisory group approach that focuses on the total of individual (licensed or not) entities of the entire group, consolidated at the level of the top holding company. In this case the solvency requirements are applied to the overall net financial position of the group as a whole.

Solo-plus supervision[11] refers to a supervisory group approach that combines the solo supervision applied to all licensed financial entities with an, in general, mainly qualitative assessment of the group as a whole, by considering all the group relations that could have an impact on the financial position of the individual licensed entities, with special attention to capital adequacy, large exposures, intra-group transactions and positions etc. In this case the solvency requirements are applied to all relevant

[9] An economic group is defined as a cohering complex of companies under (almost) common governance. A financial group is an economic group with predominantly financial activities.

[10] Solo plus supervision on the one hand and consolidated supervision on the other hand may be viewed as the most well-known existing approaches within this general definition.

[11] Consolidated supervision of a sub-group may of course be an element of solo-plus supervision of the whole group.

entities, taking into account group-induced corrections, and - as a general check – also on an aggregated basis to the group as a whole.

Group comprehensive supervision refers to a supervisory approach which fully considers the constituent entities of a financial group, the substance of the interrelationships within the group, both at the solo level and appropriate (sub) levels of aggregation, and the group as a total.

4. Current Coordination Principles

14. The coordination principles endorsed by the IAIS constitute a starting point for the formulation of coordination standards, in particular, the relevant principles from the IAIS Insurance Concordat[12] and the Joint Forum's Coordinator Principles.

15. The IAIS Insurance Concordat includes the following principles which are relevant to the exchange of information and coordination between supervisors:

Insurance Concordat Principle 1:
"No foreign insurance establishment should escape from supervision."

Insurance Concordat Principle 2:
"All insurance establishments of international insurance groups and international insurers should be subject to effective supervision."

16. The Joint Forum's *Coordinator Paper*[13] contains the following principles:

Joint Forum Coordinator Principle 1:
"Arrangements between supervisors relating to the coordination process should provide for certain information to be available in emergency and non-emergency situations."

Joint Forum Coordinator Principle 2:
"The decision to appoint a coordinator and the identification of a coordinator should be at the discretion of the supervisors involved with the conglomerate."

Joint Forum Coordinator Principle 3:
"Supervisors should have the discretion to agree amongst themselves the role and responsibilities of a coordinator in emergency and non-emergency situations."

Joint Forum Coordinator Principle 4:
"Arrangements for information flows between the coordinator and other supervisors and for

[12] Cf. IAIS, *Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Establishments*, Basel 1998, p.13. See also footnote 1. In the redrafted version of this IAIS Insurance Concordat both principles remain unchanged.
[13] Joint Forum *Coordinator Paper* in: Joint Forum, *Supervision of Financial Conglomerates*, Basel 1999, pp. 111-119.

any other form of coordination in emergency and non-emergency situations should be clarified in advance where possible."

Joint Forum Coordinator Principle 5:
"Supervisors' ability to carry out their supervisory responsibilities should not be constrained by reason of a coordinator being identified and a coordinator assuming certain responsibilities."

Joint Forum Coordinator Principle 6:
"The identification of a coordinator and the determination of responsibilities for a coordinator should be predicated on the expectation that those responsibilities would enable supervisors to better carry out the supervision of regulated entities within financial conglomerates."

Joint Forum Coordinator Principle 7:
"The identification and assumption of responsibilities by a coordinator should not create a perception that responsibility has shifted to the coordinator."

5. Coordination Standards

17. The following Coordination Standards are intended to facilitate the development of coordination and information sharing arrangements between supervisors of international insurance groups and other international financial groups which are significantly involved in insurance activities.

Coordination Standard 1:

There should be coordination arrangements between solo supervisors of insurers within an international insurance group and other international financial groups which are significantly involved in insurance activities, that will contribute to the comprehensive oversight of such groups.

18. Supervisors should assess whether coordination arrangements should be put in place for individual international insurance groups and other international financial groups which are significantly involved in insurance activities. More complexity means a greater need for a comprehensive supervisory approach, and thus for a coordination arrangement. Such assessments should take into account the characteristics of the groups, the legislative frameworks applicable, and the statutory objectives and authorities of the various supervisors involved.

19. The creation of a coordination arrangement for a specific international insurance group and other international financial groups which are significantly involved in insurance activities should provide added value in terms of prudential supervision of the group. The arrangement should also enhance the quality of the surveillance of the separate licensed entities of the group, without infringing on the responsibilities of the solo supervisors of the licensed entities in the countries where the group

is active. Any moral hazard effect stemming from the creation of a coordination arrangement should be offset by improvements to the comprehensive supervision of the group under review.

Coordination Standard 2:

A primary supervisor has the responsibility of initiating discussions to examine with the most involved supervisors the benefits of developing suitable coordination arrangements.

20. There is no need for a restrictive definition of such a primary supervisor or another apparent initiator. Several possibilities may exist, mainly depending on the specific characteristics of the concrete financial group. As examples can be mentioned e.g. the supervisor of the (licensed) top holding company, the supervisor of an important licensed entity in the jurisdiction in which the (non-licensed) top holding company is domiciled, or a supervisor in one of the most important jurisdictions in respect of the activities of the group.

21. One way for supervisors to enhance their understanding of the structure and operations of an insurance group is by conducting a mapping exercise of the group. The Joint Forum developed the Conglomerate Questionnaire for this purpose.

22. Similarly, the Joint Forum developed the Supervisory Questionnaire to aid supervisors in understanding each other's objectives and supervisory approaches. (Both documents are available on the IAIS website.)

23. Having gained an appreciation of the objectives and approaches of the other supervisors, the initiating primary supervisor, together with the other most involved supervisors, should decide whether a coordination arrangement would be beneficial and, if so, develop such an agreement.

Coordination Standard 3:

Coordination arrangements should identify the key-coordinator or a small coordination committee and the main responsibilities and procedures for the key-coordinator or coordination committee.

24. In most instances the key coordinator would be the primary supervisor. However, there may be circumstances where it would be appropriate or desirable to select another supervisor as key-coordinator or to establish a coordination committee. The Joint Forum Coordinator paper provides possible bases to assist in identifying a Coordinator for a financial conglomerate and those bases may be helpful in the case of an insurance group.

Coordination Standard 4:

Coordination agreements should include procedures for information flows between supervisors on an ongoing basis and in emergency situations, for communication with the top holding company in the group, for convening periodic meetings of the most involved supervisors and for the conduct of a comprehensive assessment of the group under review.

25. The Joint Forum Coordinator paper catalogues elements of coordination and the Framework for Supervisory Information Sharing paper outlines types of information that would be useful in an emergency situation. This paper is a good starting point to consider in the elaboration of coordination arrangements for an insurance group.

26. Various types of coordination models can be used.[14] The key-coordinator should be more than an information manager. In a more group wide approach the key-coordinator(s) would responsible for performing an overall assessment task.

27. This may include an assessment of the transparency of the group structure, fitness and propriety of the top-management, capital adequacy, internal administrative and accounting systems, internal and external auditing procedures, large intra-group transactions and exposures, and the group risk profile including large external exposures.

Coordination Standard 5:

An unrestricted exchange of prudential information (the secrecy of which should be efficaciously safeguarded between the involved jurisdictions) between involved supervisors, in emergency situations and on an ongoing basis, is a prerequisite for the development of effective coordination agreements with respect to international insurance groups and other international financial groups which are significantly involved in insurance activities.

28. In order to be able to participate in such internationally needed coordination arrangements supervisors must be able to exchange prudential information between each other. Any existing impediment to the free flow of necessary and relevant data (including qualitative knowledge such as fit and proper assessments) should be removed. In doing so, the guaranteed secrecy of received prudential information by other supervisors should under no circumstances be violated.[15]

29. Supervisors should develop a protocol with an international insurance group and other international financial groups which are significantly involved in insurance activities for obtaining factual information, possibly involving consultations with representatives of the group under review. This does not preclude the possibility that supervisors may (already) exchange information in case there are regulatory concerns before communication with the specific group.

[14] See for interesting elements of such models Annex 1 of the Joint Forum's Coordinator Paper (p. 111).
[15] With the possibility that the secrecy may to some extent be lifted in case of subpoena procedures.

30. The IAIS will be developing additional guidance on the supervision of these groups in the future, in conjunction with the work done by IOSCO, the Basel Committee on Banking Supervision, and in particular with the Joint Forum.

Appendix 1 Joint Forum Coordinator Paper

Objective

1. Given the goal of improving cooperation through information-sharing, the objective is to provide to supervisors guidance for the possible identification of a coordinator or coordinators and a catalogue of elements of coordination from which supervisors can select the role and responsibilities of a coordinator or coordinators in emergency and non-emergency situations.

Background

2. As financial conglomerates are comprised of legal entities subject to the oversight of two or more supervisors, there is a greater need for supervisors to cooperate on a cross-border and cross-sector basis. Communication and information-sharing are the sine qua non of cooperation. This paper sets out principles for that cooperation and communication between and among supervisors with respect to, primarily, internationally active financial conglomerates.

3. In this context, it may be beneficial to designate one of the supervisors involved (the "coordinator") to facilitate information-sharing efforts in a timely and efficient manner. In many cases, the coordinator will be the supervisor that carries out consolidated supervision or which is responsible for the largest part of the conglomerate.

4. Among the factors that come into play in determining whether to appoint a coordinator and, if so, in defining the role and responsibilities of the coordinator are the legal framework, statutory authorities of individual supervisors and accountabilities to legislative and other bodies, the capabilities and resources of individual supervisors, the supervisory techniques and remedial actions employed by supervisors, the ability of supervisors to share information cross-sectorally and cross-border, the business activities, risk profile and structure of the conglomerates, and the availability of information from the conglomerate to individual supervisors. The differences in such factors preclude the elaboration of a single role and a single set of responsibilities for the coordinator. Rather those differences argue for developing a catalogue of elements of coordination that supervisors could turn to in defining the role and responsibilities for the coordinator, depending on the circumstances.

5. This catalogue would include different forms of information-sharing. Supervisors could make use of this catalogue to define the role of the coordinator in emergency and non-emergency circumstances. Examples of possible roles that could be developed from the catalogue would include coordinating the exchange of information in emergencies, making group-wide assessments in emergency and non-emergency circumstances, and coordinating supervisory activities among the directly concerned supervisors. In certain circumstances, it may be appropriate not to appoint a coordinator. (For the purpose of this paper, an emergency would include, among other things, any

event, regardless of geographic origination, that would likely have a material adverse effect on the solvency or liquidity of financial conglomerates).

Factors affecting the choice of options

6. Objectives and approaches, often determined by responsibilities and authorities under national law, vary among the various supervisors involved in the oversight of regulated entities which are part of financial conglomerates. These divergences in objectives and approaches have implications as to informational and other needs of the different supervisors and will affect whether a coordinator is necessary for a particular group, the choice of a coordinator and the role and responsibilities that coordinator may have. For example, in a situation where a regulated entity in a group is subject to significant structural or supervisory firewalls that insulate the entity from the affairs of other entities in the group and is not a material entity in that group, the informational and other needs of that entity's supervisor with respect to other entities may be less than or different from those of another more significant regulated entity that is more closely integrated into the operations of other entities in the group.

7. Differences in the organisational structure of groups also have implications as to informational and other needs of the various supervisors involved. For example, in a group whose legal, business line and managerial structures diverge significantly, the supervisors of the various entities may be more interested in information about related entities and about the location and functioning of relevant controls than supervisors of entities in a more traditional group whose business activities, management and controls are organised more along the lines of the legal entities. Likewise where a group is headed by a regulated entity and that entity is subject to consolidated supervision, the needs of a subsidiary's supervisor for information about significant parts of the whole group may be different from needs of the supervisor of a subsidiary in another group that is headed by an unregulated holding company and whose regulated entities are subjected to solo supervision only. Accordingly, the role and responsibilities of the coordinator will likely be different in each case.

8. The choice of roles and responsibilities of a coordinator will also be influenced by the need to balance the benefits of improved coordination against the risks of creating (or appearing to create) a new level of supervisory oversight or an extension of a governmental safety net to additional entities, regulated and unregulated, within a conglomerate. Adding (or appearing to add) a layer of oversight or extending (or appearing to extend) a safety net can undermine market discipline, increase regulatory burden or increase moral hazard. In some jurisdictions, the desire to avoid these risks will be stronger than in others and will tend to result in a different role for the coordinator.

9. Recognition must also be given to the practical constraints facing a coordinator and these issues must be resolved before a coordinator is appointed and its role defined. For example, the choice of a coordinator and the definition of its role will be influenced by the capabilities and the extent of resources of the supervisors involved. In addition, there is a limit to the number of supervisors with which the coordinator can be in effective contact. Judgements will also need to be made on the scope and nature of the information to be shared. While flows of information from various supervisors to the coordinator should be relatively unimpeded, there may be circumstances

which affect the timing and comprehensiveness of information the coordinator shares with other supevisors, e.g. a delay may be necessary when a solution to a serious problem is in the sensitive stages or negotiation or when informing supervisors needs to be coordinated with the conglomerate's public disclosure obligations. Similarly, in an emergency, any proposed arrangements established for a coordinator cannot in any way interfere with the actions that need to be taken by relevant authorities to address the emergency. Therefore, any arrangements would necessarily have to be flexible to allow for adjustments to given circumstances.

Guiding Principles

10. The following principles provide guidance to supervisors of regulated entities in financial conglomerates in deciding on the need for and identification of a coordinator and on the role and responsibilities of such coordinator so identified.

1. **Arrangements between supervisors relating to the coordination process should provide for certain information to be available in emergency and non-emergency situations.**

11. Solo supervisors should identify the types of information needed for them to fully and efficiently discharge their supervisory responsibilities in respect of regulated entities residing in financial conglomerates. In emergencies, this would assist the information flow necessary for supervisors to assess the impact of the emergency on the entity subject to their oversight and to facilitate regulatory action, if necessary.

2. **The decision to appoint a coordinator and the identification of a coordinator should be at the discretion of the supervisors involved with the conglomerate.**

12. A single coordinator is considered generally preferable to multiple coordinators. However, there may be circumstances where it may be appropriate to share the responsibility for coordination, and more than one coordinator could be identified.

13. In most instances, it would be apparent which supervisor would act as a coordinator. In those cases where it is not apparent, the supervisors involved should decide amongst themselves who would be best suited to act in that capacity. Possible bases have been elaborated to provide some guidance in identifying a coordinator and are attached (Annex 2).

14. Information sharing in emergency situations will normally be easier if a coordinator has been identified previously since it will avoid burdening the resolution efforts by consultations on the identity and role of the coordinator. However, the circumstances of particular emergencies may require different coordinating mechanisms, including a different coordinator than the one previously identified.

3. **Supervisors should have the discretion to agree amongst themselves the role and responsibilities of a coordinator in emergency and non-emergency situations.**

15. Supervisors should establish amongst themselves the role and responsibilities of the coordinator. A catalogue of possible elements of those roles and responsibilities have been set out in Annex 1.

16. The coordinator should be expected to take the initiative in shaping the role of the coordinator and communicate its preferred approach to other relevant supervisors for their reaction.

4. Arrangements for information flows between the coordinator and other supervisors and for any other form of coordination in emergency and non-emergency situations should be clarified in advance where possible.

17. In order to facilitate the coordinator's activities, it would be beneficial for supervisors to agree to arrangements for providing and receiving information, the nature of information to be provided by supervisors to the coordinator and vice versa and under what circumstances, and for other supervisory coordination in light of the legal and organisational circumstances of both the conglomerate and the supervisors involved. Such arrangements should specify the tasks to be performed by the coordinator in terms of information gathering from regulated entities, unregulated entities where permitted by law or the conglomerate, from the various supervisors involved or from a combination of those sources. In emergency situations, arrangements made in advance may require modifications to take into account the unique properties of the emergency.

5. Supervisors' ability to carry out their supervisory responsibilities should not be constrained by reason of a coordinator being identified and a coordinator assuming certain responsibilities.

18. Solo supervisors are subject to legislative requirements and national accountabilities which may influence the timing and nature of their actions, constrain their ability to act in particular circumstances and dictate specific supervisory responses to events and developments. The identification of a coordinator does not alter these legislative requirements and national accountabilities nor does it relieve solo supervisor's lawful responsibility to take whatever actions are necessary or consult with any other party in resolving financial problems or crises.

6. The identification of a coordinator and the determination of responsibilities for a coordinator should be predicated on the expectation that those responsibilities would enable supervisors to better carry out the supervision of regulated entities within financial conglomerates.

19. There may be circumstances where a coordinator's role would be played by the supervisor carrying out consolidated supervision, so that little change would arise form the appointment of a coordinator.

20. There may be circumstances where a coordinator would not provide any added value in terms of efficiency in the supervision of regulated entities within a group. In such circumstances where other means of cooperation are assessed to be adequate by the supervisors involved, there would not be any reason to identify a coordinator.

21. Each component of the coordinator's role should be subjected to periodic critical review by the relevant supervisors to ensure that the component adds value in terms of enhanced supervision of regulated entities within a group. As the financial conglomerate's structure and activities change and as the legal and supervisory structure evolves, the need for and the role and responsibilities of the coordinator should be re-assessed.

7. The identification and assumption of responsibilities by a coordinator should not create a perception that responsibility has shifted to the coordinator.

22. It is recognised that the identification of a coordinator and the agreement between supervisors as to its role and responsibilities does not remove from the various supervisors involved their obligations under national legislation. Supervisors should avoid communications with the regulated entities or with other entities in the group which could give the impression to the group or to the market that the coordinator has assumed legal responsibility where this is in fact not the case.

ANNEX 1

Catalogue of Possible Elements of Coordination

Information Sharing **	**Group-wide assessment****	**Supervisory activities****
Adverse information is communicated by supervisors to the coordinator.	Availability of information on group-wide structure, financial condition, key group-wide exposures and intra-group exposures is ascertained periodically by coordinator.	Planned supervisory activities by supervisors is communicated to coordinator.
All relevant information is communicated by supervisors to the coordinator.	Key information on group-wide structure, "large" group –wide exposures, intra-group transactions and financial condition is maintained by the coordinator.	Planned supervisory activities by the coordinator and other supervisors are exchanged.
Coordinator stands ready to answer all inquiries from other supervisors.	Key information on group-wide structure etc. is provided to relevant supervisors if they wish to make a group-wide assessment.	Avoidance of overlap in supervisory activities through bilateral discussions of the coordinator and other supervisors.
Coordinator receives information from a variety of sources and provides key information to relevant supervisors if a problem appears to be emerging.	Coordinator makes an assessment of key areas (e.g. large exposures, financial condition and intra-group exposures) and addresses any issues with regulated entities in the conglomerate.	Participation of the coordinator in on-site visits or examinations of an institution's foreign activities where legal and appropriate.
Coordinator receives information from a variety of sources and provides key information to relevant supervisors.	Coordinator makes an assessment of key areas (e.g. large exposures, financial condition and intra-group exposures) and communicates potential problems to relevant supervisors.	Coordination of planned supervisory activities and supervisory actions when a serious problem arises crossing jurisdictional lines.
Coordinator facilitates extensive information flows under certain circumstances, e.g. emergencies.	Coordinator makes group-wide assessment and discusses observations with relevant supervisors.	Coordinated reviews or examinations of a business line crossing several legal entities, or a global risk management or control function.

*** Elements in one category are not linked in any way to the elements in other categories.*

ANNEX 2

Possible Bases to Assist in Identifying a Coordinator

The following are examples of approaches that supervisors may take in selecting a coordinator.

- Where the conglomerate is headed by a supervised bank, securities firm or insurance company, the supervisor of that parent entity, in normal circumstances, should be the Coordinator.

- Where the conglomerate is headed by a supervised bank, securities firm or insurance company but there is a dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements, an option would be for the supervisor of the dominant entity to be the Coordinator.

- Where the conglomerate is headed by a supervised holding company, the supervisor of the holding company, in normal circumstances, should be the Coordinator.

- Where the conglomerate is headed by a supervised holding company but there is a dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements, an option would be for the supervisor of the dominant entity to be the Coordinator.

- Where the conglomerate is headed by an unsupervised holding company, an option would be for the supervisor of the dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements, to be the Coordinator.

Supervisory Standard No. 6

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON THE EXCHANGE OF INFORMATION

January 2002

Supervisory Standard on the Exchange of Information

The purpose of this standard is to bring together for insurance supervisors in one document the conditions that should apply to the exchange of information. It draws on the G7 Ten Key Principles on Information Sharing; the G7 Ten Key Principles for the Improvement of International Cooperation Regarding Financial Crime and Regulatory Abuse; the Joint Forum's Principles for Supervisory Information Sharing; and the existing IAIS material on this issue, notably in the Core Principles and Insurance Concordat.

The standard applies particularly where restricted or confidential information is involved, recognising the principle that all insurance supervisors should be subject to professional secrecy constraints.[1] In many jurisdictions a considerable amount of valuable information is already in the public domain and can readily be passed on through informal exchanges. Initial contacts over the telephone, or through e-mail, can often be the most effective way of handling specific information requirements as they arise.

Contents

1. Preamble

1. An efficient and regular exchange of information between supervisory bodies, both within the insurance sector and across financial services sectors, is becoming increasingly critical to the effective supervision of internationally active insurers, insurance groups and financial conglomerates.

2. The development of complex groups and financial conglomerates, in particular, will make it more and more difficult for insurance supervisors to rely exclusively on the solo supervision of legal entities within their jurisdictions. The extent of intra-group transactions, and a concern to monitor risk concentrations within a group or conglomerate, will require more regular communications with other supervisors. The desire of supervisors in other sectors to supplement their supervision of individual entities forming part of a financial conglomerate through an assessment of the financial health of the conglomerate as a whole will increase the

[1] The Insurance Core Principles include a general duty of professional secrecy.

demands on insurance supervisors to provide information to their banking and securities equivalents both within and outside their own jurisdiction.

3. The increasing use of the internet by insurers and intermediaries is another factor creating pressure for extended and improved communications between financial sector supervisors. Internet sites can be accessed globally, and without the exchange of information and cooperation between supervisors it will prove difficult to regulate the activities of companies offering products through this medium. Supervisors will not have the same unilateral ability to protect consumers in their market. The internet will also widen the opportunities for fraudulent operators to sell bogus insurance, although on the positive side it provides the capacity for supervisors to exchange information in a more efficient and speedy manner.[2]

4. The broad principle that insurance supervisory authorities should have the capability to exchange information with each other in order to facilitate the effective supervision of insurance companies, and to help combat insurance fraud, is widely accepted. Yet the current reality would seem to be that there is little systematic information exchange between supervisory authorities in the insurance sector, or with the supervisors in other financial services sectors. Cultural factors such as the traditional reliance on solo supervision, and different legal approaches to professional secrecy/freedom of information, have restricted the development of information flows.

5. The IAIS's commitment to seek improvements in the exchange of information is longstanding. The Exchange of Information Subcommittee was one of the first to be established, and as early as the Association's Second Annual Conference in St Louis in 1995 a number of members signed an Undertaking to provide assistance on a reciprocal basis to other signatories to an IAIS Recommendation Concerning Mutual Assistance, Cooperation and Sharing of Information. The Association also approved a Model Memorandum of Understanding on mutual assistance and the exchange of information in 1997.[3]

2. Standard to be Applied

2.1 The legal framework

6. An insurance supervisory authority should have statutory power or legal authority, at its sole discretion and subject to appropriate safeguards, to share relevant supervisory information that it has obtained in the course of its own activities with:

a. other insurance supervisory authorities within the jurisdiction;

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[2] When considering exchanging information over the internet, insurance supervisors should remember that this is not a secure medium. See also Principles on the Supervision of Insurance Activities on the Internet.

[3] The primary objective of a Memorandum of Understanding is to facilitate the exchange of information between jurisdictions, but it can also be helpful in a domestic context in demonstrating the commitment to cooperation. Industry and public confidence in the way that a supervisory authority conducts its business may be enhanced if a formal structure for the exchange of information exists.

b. the insurance supervisory authorities in other jurisdictions;

c. the supervisory authorities responsible for banks and other credit institutions both within the jurisdiction and in other jurisdictions;

d. the supervisory authorities responsible for investments, securities and financial markets both within the jurisdiction and in other jurisdictions; and

e. the relevant law enforcement agencies within the jurisdiction in cases that further supervisory purposes or where financial crime, money laundering or fraud is suspected.

7. The statutory power or legal authority should permit the exchange of supervisory information both when it is in the direct interest of the insurance supervisory authority to do so, and when the insurance supervisory authority is reasonably requested to provide relevant information by one of the authorities referred to in paragraph 6a.-e. above.

8. A statutory power should provide, with appropriate safeguards, for an insurance supervisory authority to be able to gather from supervised entities information sought by one of the authorities referred to in paragraphs 6a.-d. above, or otherwise provide assistance. In the absence of specific statutory authority, a supervisor should not be prevented from gathering information or providing assistance.

9. Any existing laws that prohibit the exchange of supervisory information, without appropriate provisions permitting exchanges with the authorities referred to in 6a.-e. above, should be removed from the statute book at the earliest opportunity. Laws or procedures that unnecessarily impede the exchange of supervisory information should be amended.

2.2 Types of information covered

10. The ability to exchange supervisory information should cover, but not be limited to:

a. the management and information systems and controls operated by insurers and reinsurers;

b. the financial condition of an insurer or reinsurer;

c. objective[4] information on individuals holding positions of responsibility in insurers or reinsurers (to include owners, shareholders, directors, managers, employees or contractors);

d. objective[5] information on individuals, insurers or reinsurers involved, or suspected of being involved, in criminal activities; and

e. information on regulatory investigations and reviews, and on any restrictions imposed on the business activities of insurers or reinsurers.

[4,5] 'Objective' information is normally regarded as information that can be demonstrated to be true, for example that an individual has been publicly charged with a particular offence or found guilty by a Court of law. It would not cover hearsay or conjecture.

2.3 Decisions on sharing information

11. The decision on whether or not to share information in any particular case rests with the insurance supervisory authority concerned. In considering whether to accept or decline a request for information, the authority will in particular take account of:

a. the ability of the recipient authority to maintain the confidentiality of any information exchanged, taking account of the legal arrangements in each jurisdiction (see paragraphs 18-19 below);

b. the use to which the information will be put;

c. relevant laws and regulations in their jurisdiction; and

d. the nature of the information to be exchanged.

12. The primary purpose of exchanging information is to address material supervisory issues. Insurance supervisory authorities will seek to respond positively to appropriate requests for information taking into account any resource constraints.[6] The recipient supervisory authority should advise the authority that provided the information of any subsequent action taken on the basis of the information received.

2.4 Formal agreements and written requests

13. The insurance supervisory authority should have the ability to enter into an agreement or understanding with any other supervisor, both in other jurisdictions and in other sectors of the financial services industry, to share information or otherwise work together. Such an agreement or understanding may set out the types of information to be exchanged, as well as the basis on which information obtained by the insurance supervisory authority may be shared. The IAIS Model Memorandum of Understanding provides some guidance on some of the elements that an optimal information sharing agreement might include.[7]

14. Formal agreements are particularly valuable where there is a need to provide a basis for a continuing relationship between the supervisors in two jurisdictions, or between supervisors responsible for different financial sectors.[8] However, whilst information sharing agreements can be used to establish a framework among supervisors to facilitate the efficient execution of requests for information, the existence of such an arrangement should not be a prerequisite for information sharing.

15. Whilst formal requests for information should be in writing from a verifiable source, insurance supervisory authorities should not insist on written requests in an emergency

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[6] Where language difficulties arise, and in the absence of any specific agreement between the parties concerned, the cost of translating any information exchanged will generally fall to the authority requesting the information.

[7] The Model Memorandum of Understanding covers a number of issues in some detail. These include the general principles to be applied, scope, requests for information and assistance, procedures for taking testimony (where applicable), permissible uses and confidentiality, and consultations between the parties.

[8] For example, a formal agreement between two (or more) supervisory authorities may be considered in order to facilitate the supervision of a major group or conglomerate.

situation where the supervisor is known to them. The expectation is that oral requests will be confirmed in writing, but the absence of written confirmation should not delay a response where such a response would otherwise be appropriate. To facilitate the exchange of information, insurance supervisory authorities may wish to consider nominating an individual to act as their main contact point.

2.5 Reciprocity requirements

16. Information sharing agreements should allow for the two-way flow of information, but strict reciprocity in terms of the level, format and detailed characteristics of the information exchanged should not be required. Similarly reciprocity should not be a strict precondition for the exchange of information where no information sharing agreement is in place.

17. It is accepted that the principle of reciprocity may be a consideration in a decision on whether or not to comply with a specific request. However, the lack of reciprocity should not be used by an insurance supervisory authority as the only reason for not exchanging information that it would otherwise be appropriate to share in an emergency or other serious situation. In that case any information will be taken as strictly confidential.

2.6 Confidentiality

18. The insurance supervisory authority is required to keep confidential any confidential information received from other supervisors or law enforcement agencies, except where constrained by law or in situations where the supervisor or law enforcement agency who provided the information, or the subject of the information, provides authorisation for its release. In the event that an insurance supervisory authority is legally compelled to disclose confidential information it has received from another authority, the supervisor should promptly notify the authority that originated the information, indicating what information it is compelled to release and the circumstances surrounding the release.

19. Freedom of information provisions should not override the confidentiality requirements applying to the insurance supervisory authority in respect of information received from other supervisors or law enforcement agencies where confidentiality is necessary for sound regulatory practice or effective communications with the other supervisor or agency.

20. With the exception of confidentiality requirements, an insurance supervisory authority should not seek to limit unduly the use of information provided by it for supervisory purposes. Depending on the legal arrangements in the jurisdiction, such supervisory purposes may include the use of the information in connection with administrative or civil proceedings or criminal cases in which the authority is involved.

21. In cases that further supervisory purposes, the insurance supervisory authority should generally be willing to permit information provided by it to be passed on to other supervisory or law enforcement agencies in the jurisdiction of the recipient that meet equivalent confidentiality requirements. Prior to passing on the information, the initial recipient in the

jurisdiction should consult and seek the agreement of the supervisor that originated the information, who may attach conditions to its release.

22. Jurisdictions where information received by the insurance supervisory authority from another supervisor or law enforcement agency cannot be kept confidential are urged to review their requirements.

2.7 Financial crime

23. Where an insurance supervisory authority identifies suspected financial crime activity – including fraud – in supervised insurers or reinsurers, they should ensure that the information is shared with the relevant law enforcement agency in their jurisdiction. The law enforcement agency should be able to use the information for the full range of its responsibilities subject to any necessary limitations established at the outset.

24. The law enforcement agency should be subject to legal requirements so that it is bound to maintain the confidentiality of any restricted information provided to it by the insurance supervisory authority. The law enforcement agency should normally only pass on the information to other law enforcement agencies with the consent of the insurance supervisory authority, and subject to any confidentiality requirements.

Supervisory Standard No. 7

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON THE EVALUATION OF THE REINSURANCE COVER OF PRIMARY INSURERS AND THE SECURITY OF THEIR REINSURERS

January 2002

Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers

This standard provides guidance to supervisors in assessing how insurers manage their reinsurance arrangements. It discusses the policies and procedures that companies should have in place and supervisory approaches for evaluating the adequacy of each company's reinsurance cover.

The IAIS recognises that currently there are significant differences in supervisory approaches taken by member jurisdictions with respect to reinsurance. For example, reinsurers in some jurisdictions are directly supervised; other jurisdictions rely on rating agencies in assessing the security of a reinsurer. Some supervisors maintain a register of those reinsurers authorised to underwrite reinsurance in their jurisdiction, while others evaluate reinsurers actually writing business in their jurisdiction. Some jurisdictions require reinsurers to post collateral, covering the likely liabilities (or liabilities plus a margin) of the reinsurer, with the ceding companies

This standard acknowledges the differing practices but does not purport to favour one regime over another.

In addition, in recent years reinsurance has evolved with the introduction of many new products. These are commonly known as alternative risk transfer (ART) products. The IAIS intends to issue a separate paper on this subject, however, it believes that much of the guidance provided in this standard will also apply in the case of ART products.

Contents

1. Introduction

1. Insurance companies assume risk on behalf of policyholders. They mitigate these risks by acquiring insurance with reinsurers. Through the use of reinsurance, an insurer can reduce risk, stabilise its solvency, use available capital more efficiently and expand underwriting capacity. Reinsurance helps an insurer obtain a desired, prudent risk profile.[1] However,

[1] The risk profile of a financial undertaking reflects the relation between the risks run by the financial undertaking and its financial strength.

irrespective of the reinsurance obtained, the primary insurer normally remains contractually responsible for paying the full claim amounts to policyholders.

2. Reinsurance may be provided by pure (or professional) reinsurers or by primary insurers also authorised to write reinsurance.

2. Types of reinsurance arrangements

Traditional

3. Most risk assumed by reinsurers is based on traditional contracts, which are normally either "treaty" or "facultative". Under treaty contracts, the reinsurer automatically participates in certain sections or portfolios of the insurer's business (treaty contracts are also referred to as automatic reinsurance or automatic capacity). Facultative contracts allow the reinsurer to participate on an individual, risk-by-risk basis.

4. Contracts may be proportional or non-proportional. Proportional reinsurance is a form of reinsurance in which the premiums and claims of the insurer are shared proportionally by the insurer and the reinsurer. In non-proportional reinsurance an insurer pays a risk premium to a reinsurer and the reinsurer assumes a share of the insurer's obligations in excess of a certain amount which could be limited by another, larger, amount. Thus the reinsurance cover can be built up in layers. Typically, for non-life insurance, reinsurance contracts last one year and cover specified lines of business. Life reinsurance contracts are usually indefinite and contain a termination provision for new business only.

ART

5. Insurance risk may be transferred to reinsurers and other counterparties by using ART techniques, such as financial reinsurance and securitisation. Securitisations commonly utilise either a "protected cell" or a "Special Purpose Vehicle" to effectuate the transfer of insurance risk from the ceding company. To date, most securitisations have been fully funded, which means that the proceeds of the securitisation fully cover the risk securitised.

6. Similar cover can also be provided by other types of ART contracts some of which are provided by reinsurers. ART cover may be obtained on a multi-line, multi-year, and holistic basis, and can be retrospective or prospective. Contracts can provide protection against different operational and financial risks. For example, some ART contracts, like traditional reinsurance contracts, protect a primary insurer's solvency.

7. In some ART contracts the transfer of insurance risk is secondary to the transfer of financial risks, such as credit, liquidity or market risk. While called financial "reinsurance", most jurisdictions regard that such contracts provide valid reinsurance cover only to the extent they imply a real transfer of insurance risk. However, such contracts do play a part in the company's risk management; but they should not be considered to mitigate insurance risk unless there is a genuine transfer of this risk. In some cases the only intention of the cedent is to

obtain a favourable impact for financial reporting, but ART contracts should not be used in order to distort true and fair reporting.

3. Reinsurance strategy and management procedures

Board of Directors

8. Every insurer should have a reinsurance strategy, approved by the company's Board of Directors, that is appropriate to the company's overall risk profile. The reinsurance strategy will be part of the company's overall underwriting strategy. The Board should review the reinsurance strategy annually (in the case of life insurers, possibly less frequently). In addition, the reinsurance strategy should be reviewed when there have been changes in the company's circumstances, its underwriting strategy, or the status of its reinsurers.

9. The reinsurance strategy should define and document the insurer's strategy for reinsurance management, identifying the procedures for:

- the reinsurance to be purchased;
- how reinsurers will be selected, including how to assess their security;
- what collateral, if any, is required at any given time; and
- how the reinsurance programme will be monitored (i.e. the reporting and internal control systems).

10. The Board should ensure that all legal and regulatory requirements are met. It should set limits on:

- the net risk to be retained; and
- the maximum foreseeable amount of reinsurance protection to be obtained from the approved reinsurers.

Senior management

11. Senior management should document clear policies and procedures for implementing the reinsurance strategy set by the Board of Directors. This includes:

- setting underwriting guidelines that specify the types of insurance to be underwritten, policy terms and conditions, and aggregate exposure by type of business;
- establishing limits on the amount and type of insurance that will be automatically covered by reinsurance (e.g. treaty reinsurance); and
- establishing criteria for acquiring facultative reinsurance cover.

In order to avoid uncovered risks, the terms and conditions of the reinsurance cover should be compatible with those of the underlying business.

12. Limits on the net risk to be retained should be set either per line of business or for the whole account. The insurer may also set limits per risk or per event (or a combination thereof).

The limits must be based upon an evaluation of its risk profile and the cost of the reinsurance. In particular, the insurer should have adequate capital to support the risk retained. Some insurers may use the results of dynamic financial analysis techniques[2] (using the reinsurance cover as one of the variables) as input into these operating decisions.

13. The insurer should maintain an up-to-date list of reinsurers[3] that it has approved. For each approved reinsurer the appropriate level of exposure should be specified. To do this, the insurer should evaluate the ability and willingness of the reinsurer to fulfil its contractual obligations as they fall due (i.e. its security). Such assessment is required whether collateral is posted or not. The assessment should take into account the effects of any collateral the reinsurer has posted in favour of other insurers. The insurer's credit guidelines should describe the system for controlling exposures to each reinsurer.

14. To improve the security of the overall reinsurance cover, insurers may choose to use a number of different reinsurers. Diversification may also be achieved by using certain ART techniques.

15. Generally speaking, if no requirements are placed on the choice of reinsurer or on the posting of collateral, the fewer the number of reinsurers used, the more an insurer should pay importance to the security of its reinsurers. If a company takes advice on the strength and security of a reinsurer, then it should satisfy itself that the advice given is sound. Similarly, if reinsurance cover is acquired through an intermediary, the company should evaluate the operational risk associated with the transaction.

16. Senior management should ensure that the management information system in place meets all Board requirements with respect to reporting frequency and level of detail. In addition, there should be adequate systems of internal control to ensure that all underwriting is carried out in accordance with company policy and that the planned reinsurance cover is in place. The underwriting control systems should be able to identify and report on a timely basis where underwriters infringe authorised limits, breach company guidelines or otherwise assume risks exceeding the ability of the company's capital base and reinsurance cover to service.

Internal control

17. There should be internal control systems in place to ensure that claims are reported to the appropriate reinsurer and that reinsurance claims payments are being promptly collected. The underwriting control may include an actuarial assessment of the risk and whether it has been transferred as presumed. This assessment may also include a review of the reinsurance

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[2] Dynamic financial analysis evaluates an expanded universe of possible scenarios through computer modelling, as opposed to the traditional approach that involves interpreting historical trends and ratios (i.e. static). With the power of a computer, a user can simulate multiple scenarios based on specified set of constants and probabilistic estimates for key variables, such as reinsurance pricing and coverages, premium volume, pricing adequacy, underwriting profit/loss, investment returns, reserve adequacy, catastrophes and cost of capital. The resulting distribution of these variables can then be used to influence management's operating decisions.

[3] Cf. The OECD Recommendation of the Council on Assessment of Reinsurance Companies, C(98)40/FINAL.

contracts. The Board of Directors should receive regular and comprehensive reports on the effectiveness and performance of the claims system and the reinsurance protection. Companies' internal control systems should be subject to regular audit examination.

4. Supervisory regime for insurance business (reinsurance cover and security)

18. The supervisor should verify that the Board of Directors has established an overall strategy framework – addressing, *inter alia*, underwriting and reinsurance. To evaluate reinsurance cover, reinsurer security and collateral that may be posted, the supervisor should have, or have access to, sufficient expertise. Usually the supervisor takes a risk-based approach – ensuring that the company has appropriate policies, systems and procedures in place and focusing more detailed examination work on areas posing specific and significant concern.

19. Before granting a license, the supervisor must be satisfied with the company's planned risk management and reinsurance strategies, and accompanying policies. When examining the business plan of an insurance company, the supervisor must evaluate if the proposed reinsurance covers maximum foreseeable loss. In the business plan the company must describe how, and to what extent, future policies will be reinsured. The supervisor should evaluate whether reinsurers offer sufficient security. In most cases, this evaluation could be enhanced or improved by the exchange of information between supervisors.

20. Companies should maintain adequate reinsurance cover at all times. Supervisors should regularly evaluate the reinsurance cover and risk profile of the insurers. While many reinsurance treaties operate on an annual basis, some treaties especially for life business and some ART contracts can operate for many years. In such cases, supervisors will wish to be assured that the reinsurer offer sufficient security to act as a long-term counterparty

21. Supervisors must receive sufficient and relevant information on the reinsurers used and the reinsurance cover arranged. Relevant information may include:

- reports describing the reinsurance cover, reinsurance programmes or treaties; and
- financial statements, including the result of reinsurance, any amounts outstanding from reinsurers and the effect of ART techniques, including financial reinsurance.

Supervisors should be able to review the quality and validity of information submitted.

22. The information may be submitted in the form of:

- copies of contracts and amendments;
- copies of slips and cover notes;
- supervisory returns; or
- written contract descriptions and summaries.

Information obtained by supervisors in the process of assessing a company's reinsurance cover should be kept confidential.

23. Using this information and other relevant information received during on-site inspection, the supervisor should evaluate:

- the prudence of the company risk profile including an evaluation of any risk concentration, i.e. an aggregate exposure with the potential to produce losses large enough to threaten the insurer's financial health or its ability to maintain core operations;
- compliance with the company's reinsurance strategy;
- the sufficiency of the reinsurance cover and the insurance company's financial strength, in particular under extreme, but plausible loss scenarios;
- the sufficiency of the reinsurance security, taking into consideration a wide range of factors including financial strength, whether reinsurers are properly supervised and whether or not collateral is posted, cf. para. 13 above; and
- the appropriateness of any ART techniques, such as securitisation, used.

24. In making these evaluations the supervisor should consider the overall risk profile of the insurer. The supervisor should be aware of the security and adequacy of the reinsurance or ART coverage for long-tail business (where claims development is slow) and the top layers of catastrophe programmes (where amounts involved can be large).

25. The choice of reinsurance cover is a business decision made by management within the overall reinsurance strategy of the insurer. However, where insufficient or inappropriate reinsurance cover affects the company's ability to pay policyholders' claims, the supervisor must enter into discussions with the management of the company. The supervisor should have the legal and administrative power necessary to take remedial action in *inter alia* cases of insufficient reinsurance cover, insufficient reinsurer security, non-compliance with company reinsurance strategy, insufficient collateral (where applicable) or use of non-admitted (i.e. non-authorised) reinsurers.

26. Remedial action should include the power to disallow credit in whole or in part for reinsurance when calculating solvency requirements or technical provisions on a net basis or when determining the coverage of gross technical provisions by reinsurance recoverables. As well, the supervisor should be able to require the insurer to:

- obtain additional reinsurance cover;
- provide additional capital;
- establish additional technical provisions; and
- have additional collateral posted, if applicable.

Such action should be taken according to transparent principles and be based on objective criteria.

27. The supervisor may choose to provide insurers with comparative risk information, for example in the form of benchmarking data or comparisons. This information allows management to evaluate the quality of the reinsurance cover in comparison with market standards and to decide if its risk profile is acceptable and prudent.

Supervisory Standard No. 8

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

STANDARD ON SUPERVISION OF REINSURERS

October 2003

[This document was prepared by the Reinsurance Subcommittee in consultation with members and observers.]

Standard on supervision of reinsurers

With the adoption at the 2002 IAIS General Meeting of *Principles on minimum requirements for supervision of reinsurers,* insurance supervisors around the world are expected to supervise reinsurers domiciled in their jurisdictions.

Furthermore, the principles anticipate a global approach to the regulation of reinsurers. In such a system, the onus is placed on the home supervisor of the reinsurer. The home supervisor is responsible for effective supervision of the business worldwide and is responsible and expected to communicate effectively with supervisors in other jurisdictions where the reinsurer writes business[1]. Minimum requirements help define a minimum level of acceptable security of reinsurers. These are needed to ensure that market stability and ultimately the interests of policyholders are protected. However, as stated in the *Supervisory standard on the evaluation of the reinsurance cover of primary insurers,* it is the responsibility of the ceding insurer to evaluate the security of proposed reinsurers and the duty of that ceding insurer's supervisor to ensure that the evaluation is adequate.

The principles state:

Principle 1: Regulation and supervision of reinsurers' technical provisions, investments and liquidity, capital requirements, and policies and procedures to ensure effective corporate governance should reflect the characteristics of reinsurance business and be supplemented by systems for exchanging information among supervisors.

Principle 2: Except as stated in Principle 1, regulation and supervision of the legal forms, licensing and the possibility of withdrawing the license, fit and proper testing, changes in control, group relations, supervision of the entire business, on-site inspections, sanctions, internal controls and audit, and accounting rules applicable to reinsurers should be the same as that of primary insurers.

This standard elaborates on Principle 1, focussing particularly on where reinsurers differ from primary insurers, hence requiring the supervisory framework to be adapted. The standard applies to internationally active reinsurers that are pure reinsurers or insurers, whose main activity includes the issuance of reinsurance coverage, having cedants in at least one jurisdiction outside their own. The standard also applies to domestic reinsurers to the extent that it is relevant. Supervisors may choose to apply the standard to insurers whose main activity is the issuance of insurance but who also provide a material amount of reinsurance coverage.

Supervisory requirements include **financial strength**, **supervisory review** and **disclosure requirements**. These different aspects of the supervisory framework must be adapted according to the nature of the customers and the characteristics of the risks assumed. As stated in paragraph 7 of the *Principles on minimum requirements for the supervision of reinsurers* a global supervisory framework envisages moving towards a system of accreditation of home supervisors. As this standard becomes more widely adopted and implemented, it may become one of the building blocks in the eventual development of such an accreditation system.

This standard focuses on the supervisory review aspect of the framework. As stressed in the *Insurance core principles*, effective supervision can only be accomplished if home supervisors have

[1] When the word supervisor is used in this standard it means the home supervisor of the reinsurer (i.e. the supervisor in the jurisdiction in which the reinsurer is incorporated) except where the context implies otherwise

adequate powers and resources. The role of the supervisory review process is especially significant for home country supervision, particularly in the absence of international standards for financial strength requirements. In this regard the IAIS Solvency Subcommittee, with input from the International Actuarial Association, is developing the various components of a harmonised international approach to assessing solvency and capital adequacy.

Disclosure aspects will be addressed by the IAIS Subcommittee on Enhanced Disclosure and previous and subsequent standards and guidance papers. Due to the professional nature of the customers, disclosure should improve market discipline and thus provide an important adjunct to supervisory review. In order to facilitate market discipline financial statements of internationally active reinsurers should be prepared using internationally accepted accounting principles e.g., International Financial Reporting Standards (IFRS)[2] or U.S. generally accepted accounting principles (GAAP), and should be publicly available.

In supervising reinsurers, home supervisors should refer, where appropriate, to the *Insurance Core Principles* and other relevant IAIS documents for guidance in areas not covered in this standard.

Contents

1. Technical provisions

Technical provisions for non-life reinsurers

1. Estimates of provisions, including loss provisions, are inherently uncertain as they attempt to reliably give an insight into future claims emergence. This uncertainty may be more pronounced in reinsurance than in primary insurance, particularly for non-life business.

2. The challenges reinsurers may face when setting technical provisions include:

- Estimating adequate technical provisions – for example, when costs of claims, particularly for excess of loss contracts, are driven up by inflation, changes in life expectancy or more stringent liability laws
- Longer reporting lags – there is an inherent delay because claims are first reported to and evaluated by the cedant. This can sometimes be exacerbated by a periodic notification interval to the reinsurer and by the retrocession process.
- Differing interpretations of reinsurance terminology
- Scarcity of industry data and statistics – homogenous data is difficult to collect by account and by industry

[2] Issued by the International Accounting Standards Board, IASB (previously called IAS)

- Heterogeneity of data received – cedants may pay, establish provisions and code information differently
- Selective cedant information – cedants may filter data provided to reinsurers, report on a different basis (e.g., by accident year instead of underwriting year), change their claims handling and reserving practices or make errors in data transmission
- Differing patterns in reporting information - patterns can differ depending on contract type, line of business, specific contract conditions, cedant and intermediary

3. Recognising that there may be delays in the claims reporting process and that information may often be incomplete, reinsurers establish provisions for claims incurred but not reported (IBNR). Reinsurers should ensure that cedants provide them with cedant relevant and timely information on an ongoing basis so that the extent of possible claims can be anticipated and reliably estimated. For example, for an excess of loss contract a reinsurer should require the cedant to report accumulated losses when they reach a certain level; this level should be set below the trigger level in the contract.

4. Supervisors should understand the techniques used by reinsurers and their actuaries in setting technical provisions with specific focus on those used to arrive at IBNR provisions. The IAIS discussion paper, *Quantifying and assessing insurance liabilities*, provides useful background material.

General issues relating to life and non-life reinsurers

5. Reinsurers have developed a number of techniques to deal with the general challenges of estimating technical provisions. For example, they use a variety of quantitative techniques to estimate the ultimate cost of claims as reliably as possible. These techniques, however, must be supplemented by professional and managerial judgment, using in-house or outside information as well as input from experts in both risk and claims assessment. Reinsurers should check data and other relevant information received from cedants and reinsurance brokers against historical data. They should be able to explain if a claim provision is not at least as high as the amount reported by the cedant or broker. Because of the issues mentioned above, there must be close cooperation at least between the reinsurer's underwriters, actuaries, claims managers and accountants.

6. Contracts between the cedants and the reinsurers lay down the terms and conditions to be followed by the parties, specifying for example, the length of the contract, premium payments, commissions, claims reporting time frames, and claims payment terms and time frame. Reinsurers should communicate with their cedants and their brokers regularly as this relationship is essential for reinsurers in order to be able to reliably establish technical provisions. In particular, the reinsurer should understand the risks assumed by each particular cedant and have a comprehension of the overall developments in the marketplace. Ongoing communication should be maintained throughout the life of the contracts so that reinsurers can react properly to changes in claims experience and development, and other relevant factors.

7. Reinsurers should have an in depth knowledge of the underwriting policy and the claims handling procedure of cedants and should be informed about any material changes. This may be obtained by collecting appropriate information from cedants on a regular basis in agreed formats and quality. The contract terms between the reinsurer and cedant also often provide that the reinsurer has the right and ability to conduct claims audits of the cedants.

8. In addition, reinsurers need to monitor market conditions and follow industry and societal trends. They should take note of past experience and expectations of inflation and more stringent liability laws. Reinsurers should follow claims payments developments to be able to identify changes or anomalies early.

9. Along with its annual audited financial statements and statements that include adequate disclosures concerning technical performance and risks, a reinsurer should provide detailed information for each reporting segment to the supervisor upon request. The supervisor may wish to require information on non-standard transactions such as the use of CAT bonds. The information should be supplemented by an opinion by a qualified actuary or other competent person on, at least, the adequacy of the technical provisions.

10. The supervisor should review the claims payment development, assessing it against past trends and where possible against similar information provided by reinsurers that accept similar type of risk, or are of a similar size or in a similar market. They should also review run off results and claims development statistics, as well as the reinsurer's risk management systems which may include internal risk models, scenario analyses and sensitivity and stress testing. These should include effects from each line of business on all relevant balance sheet items.

11. The supervisors should review information provided by reinsurers, particularly when they suspect problems. This capability can either be provided by in-house staff or by contracting out as long as confidentiality requirements are respected and conflict of interest safeguards apply.

12. In addition to understanding the techniques, the supervisor should review the procedures used by the reinsurers to verify the results and to compensate for information delays and weaknesses in the data.

2. Investments and liquidity

13. Internationally active reinsurers operate in more than one market, managing global portfolios of assets and liabilities. In addition to the risks run by primary insurers, reinsurers' mismatches between assets and liabilities may imply potentially significant exposure to currency risk. Reinsurers providing long-term coverage, such as life reinsurance, may face investment risk depending on the terms of the reinsurance contract.

14. Reinsurers should manage their assets and liabilities in a prudent manner. They should invest in assets that in terms of security, return, diversification and marketability cover their expected obligations as they fall due. Asset-liability matching policies should be subject to regular stress testing and scenario analysis. The scenarios tested should reflect the unique risk profile of the reinsurer. For example, reinsurers should test any unmatched assets and liabilities, against changes in interest and exchange rates. Stress testing and scenario analysis should also be used in relation to market and credit risk in general, including credit insurance[3] and reinsurance recoverables. The supervisor should assess capital adequacy, liquidity and currency matching in light of the results of the stress testing. In addition, reinsurers should manage and monitor the counterparty credit risk inherent in the business.

15. Often reinsurers and cedants work with current accounts (i.e., accounts in which premiums are credited and claims are debited). However, because of the types of coverage provided (e.g., catastrophe coverage) reinsurers are sometimes obliged to reimburse large-scale losses of cedants on demand. As a result, they should ensure that they maintain sufficient investments in liquid financial assets[4]. Alternatively, they should ensure that liquidity is easily and readily accessible through other means, for example secure lines of credit, in order to pay large and unexpected losses without having

[3] In the US known as financial guarantee insurance

[4] Assets pledged as collateral can not be regarded as liquid

to sell a significant portion of their investments, particularly during periods of adverse market conditions or at short notice.

16. Along with the annual audited financial statements, the supervisor should receive reports concerning investment performance and risks from reinsurers. On a regular basis or upon request, a breakdown of the investment portfolio by asset and rating class and currency should be provided. Reinsurance recoverables are considered as an asset class in this respect. Derivatives are to be reported according to their underlying assets based on their notional amounts and fair value. Reinsurers should report what proportion of their asset portfolio has been pledged to primary insurers or other counterparties.

17. The supervisor should analyse this information over time and compare it to similar information on reinsurers that accept comparable type of risk or are of a comparable size or in comparable markets. The supervisor should then discuss the results with the reinsurer focusing specifically on key risks and how they are being managed and matched.

18. The supervisors should refer to the *Supervisory standard on derivatives* and the *Supervisory standard on asset management by insurance companies* for guidance when assessing a reinsurer's investment portfolio, as well as its investment policies, reporting and internal control procedures.

3. Economic capital requirements

19. Regulators cannot prevent every failure. Prudential measures such as the establishment of regulatory capital requirements are put in place, however, to minimise the probability of such failures and their potential costs to the cedants and possible impact on policyholders.

20. Reinsurers need to hold capital to manage their overall risk against the possibility of insolvency, the risk undertaken through reinsurance contracts and assets, and other risks such as operational risk. On an individual contract basis reinsurers may assume more volatile risks than primary insurers - for example, by providing coverage for catastrophic events. However, this may be mitigated by better risk diversification on a global portfolio basis. Volatility may be caused by hardening or softening of markets through varying reinsurance prices, as well as volatility in the capital markets. Reinsurers should calculate their risk profile including the above risks as adequately as possible, and manage it against their risk appetite, as set by the board of directors, (e.g. using probability of ruin/default) by allocating sufficient capital reflecting the risk profile and the defined period of time.

21. Reinsurers should use models for internal management purposes to analyse their risk profile. Some risks faced by reinsurers are similar to those of primary insurers. Whereas a primary insurer faces the credit risk that its reinsurers may not fulfil their obligations, for example, a reinsurer faces the same risk with its retrocessionaires. Both face underwriting risk, although particular aspects of underwriting risk - such as the risk of cumulations, can be - but does not necessarily have to be - more acute for a reinsurer. Similarly, as noted above, both face investment risks, the significance of which can differ depending on the global reach and lines of business underwritten.

22. Where the risk profile has life insurance attributes, reinsurers' economic capital must allow for the specific risks arising from the reinsurance contract structure. Life reinsurance can include long term premium guarantees and exposure to selective options, either in the contract with the cedant or in the contract between the cedant and the policyholder. Long term premium guarantees expose the business to adverse trends. Changes in investment conditions can expose embedded options. These need to be identified, understood and adequately priced, and subsequently monitored and mitigated. Supervisors should expect reinsurers to adopt best market practice to control such risks.

23. In addition, like primary insurers, reinsurers are exposed to a variety of operational risks such as those arising from employees (e.g., mis-management, human error and internal fraud), technology (e.g., technological failure and deteriorating systems), customer relationships (e.g., contractual disputes) and external sources (e.g., external fraud or changes in legal interpretations).

24. Reinsurers should provide information to the supervisor about their overall risk profile i.e. the relation between the risks run and their financial strength. The supervisor should review the risk profile and all other relevant information with the reinsurer. In the case of internationally active reinsurers, the supervisor should review information about the amount of risk (e.g. using the probability of ruin/default) the reinsurer considers to be the maximum acceptable. In such cases, the supervisor should monitor whether the current risk appetite is within the acceptable range taking into account the international nature of the business. The supervisor should monitor the capital held by reinsurers on a global basis.

25. The supervisor should have the capability either by using in-house staff or contracting with outside experts (who would be subject to confidentiality and conflict of interest requirements) to review reinsurers' models, seeking to ensure that the models adequately reflect the unique risk profile of the business, including whether the business is long-tail or short-tail, as well as the potential for large claims and volatility. Frameworks for establishing economic capital should take into account countervailing factors, such as a adequately diversified reinsurance book, that could mitigate the extent of overall losses. They should not only consider risks individually but also in total, bearing in mind the effects of dependencies, such as when a reinsurer's investments, its issued financial guarantees, if any, and/or its retroceded risks are with the same counterparty.

26. For reinsurers that are part of a group, models should take into account intra-group exposures and highlight the potential for double gearing[5] and contagion. Economic capital targets should be set for operations for the reinsurer as a whole and in specified areas as well.

27. Generally, internationally active reinsurers, or their holding companies, are evaluated by at least one reputable rating agency. Supervisors should seek to benefit from rating agency information to learn more about the companies they supervise. When a reinsurer has a declining rating or loses an investment grade rating, the supervisor should seek an explanation.

4. Corporate governance

28. Corporate governance refers to the manner in which boards of directors and senior management oversee the business and affairs of the reinsurer. In particular, their responsibilities include establishing and maintaining policies and procedures regarding risk management, internal controls, reporting, and auditing and ensuring that the reinsurer complies with the statutory and supervisory obligations imposed on it.

29. Given the specific nature of the reinsurance business reinsurers should have appropriate policies and procedures covering:

- *Underwriting*
  Policies should be in place identifying the lines of business and types of risks to be assumed by the reinsurer by location. Appropriate procedures for implementing and monitoring the policies

[5] The term double gearing is used to describe a situation where the same capital is used simultaneously as a buffer against risk in two or more legal entities of a conglomerate

should be established. They should include a review of the terms and conditions of the contracts to ensure that they are accurate and clearly understood. The underwriting guidelines should, where appropriate, require the reinsurer to obtain sufficient information on the cedants with whom it deals to assess their integrity, management and business policy.

- *Accumulations of exposures (e.g. catastrophe exposure such as storm, quake, flood, hail and man made disasters)*
  The reinsurer should identify, monitor, and measure any concentration of risk on the underlying lines of business and on the portfolio as a whole due to one and the same event. It should set limits on the whole portfolio and, where appropriate, per line of business to limit the effect of a situation where several lines are hit by the same event or the same underlying cause. Where necessary, there should be risk assessment models for catastrophes and supervisors should have the capability, either with in-house staff or by engaging external experts (who may be subject to confidentiality and conflicts of interest requirements), to assess the controls over a reinsurer's catastrophe exposures.

- *Provisioning*
  Reinsurers should have policies and procedures in place for establishing technical provisions. They should adequately address the specific challenges faced by reinsurers, particularly with respect to establishing IBNR provisions.

- *Retrocession (cover and security)*
  Like primary insurers, reinsurers should define and document their strategy for retrocession management, identifying the procedures for:
  - the retrocession to be purchased
  - how retrocessionaires will be selected, including how to assess their security
  - any limits on retrocession to any one retrocessionaire
  - what collateral, if any, is required at any given time
  - how the retrocession programme will be monitored (i.e. the reporting and internal control systems).

  In their strategy for retrocession management, reinsurers should take into account that there may be situations where the reinsurer finds itself unable to place retrocession with a retrocessionaire with an acceptable level of security.

- *Contract conditions*
  The reinsurer should identify, monitor and control any special retrocessional contract conditions, such as aggregates, that will affect the amount recoverable from a retrocessionaire.

- *Contracts*
  Reinsurers should establish a process whereby contracts are reviewed and approved on a timely basis

- *Investments*
  A reinsurer's investment policy should reflect the global nature of the business and specifically deal with asset/liability management, asset diversification, liquidity, and cash flow, considering the group structure. It should identify approved investments, set limits by asset class, describe what assets are considered to be suitable matches for the long tail and the short tail business and how various risks will be managed - for example, what the reinsurer does to manage currency risk when it insures risks in several countries. The investment policy should have concentration limits, such as limits for investments in companies or groups and limits on investments in particular industry sectors. The reinsurer should have procedures in place to monitor and control

its investment policy against the limits approved by the board of directors and within regulatory constraints, if any.

30. The supervisor should review the reinsurer's corporate governance policies and procedures, including its system of internal controls, to ensure that they address the nature of the risk undertaken.

5. Exchange of information

31. The home supervisor of an internationally active reinsurer has the duty to communicate with supervisors in the jurisdictions in which the reinsurer underwrites reinsurance and who are relying on the work of the home supervisor. At the request of the supervisor in the host jurisdiction, the home supervisor should provide relevant financial and other supervisory information, including factual information on individuals holding positions of senior responsibility in the reinsurer to the extent that such information is relevant to the host supervisor's supervisory responsibilities.

32. A formal agreement is not a prerequisite for sharing information, but it is desirable in order to clearly set out the conditions of the information exchange. In any case, supervisors in host jurisdictions who receive confidential information from the home supervisor must agree to keep the information confidential. The *Supervisory standard on the exchange of information* sets out the conditions that should apply when insurance supervisors exchange information. In addition, supervisors may wish to refer to the *OECD: Decision on the exchange of information on reinsurers, C(2002)134.* Where memorandums of understanding or multilateral agreements exist, these should be extended to cover reinsurers.

33. The home supervisor should inform supervisors in host jurisdictions of any material changes in supervising a reinsurer that have a significant bearing on the operations of the reinsurer. In particular the home supervisor should inform the supervisor in the relevant host jurisdiction when withdrawing a license or taking action that will affect the operations of the reinsurer in that jurisdiction.

34. Equally, supervisors in the host jurisdiction should inform the home supervisor of any material circumstances or concerns that could affect the reinsurer.

35. The IAIS database on reinsurers supports the exchange of information by providing data on reinsurers in different jurisdictions. Members can obtain information on whether a reinsurer is licensed and supervised in another country or review its annual accounts over a number of years. When using the database, members should be aware that the completeness and accuracy of the information is dependent on members' efforts, and when in doubt should contact the relevant supervisor directly for validation.

36. Exchange of information should not be limited to company specific information. Through discussions supervisors learn from each other's experiences. For example, a supervisor may learn about new approaches to estimating technical provisions for catastrophes from another supervisor facing similar risks.

Supervisory Standard No. 9

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

STANDARD ON DISCLOSURES CONCERNING TECHNICAL PERFORMANCE AND RISKS FOR NON-LIFE INSURERS AND REINSURERS

OCTOBER 2004

This document was prepared by the Enhanced Disclosure Subcommittee,
in consultation with members and observers.

Standard on disclosures concerning technical performance and risks for non-life insurers and reinsurers

The purpose of this standard is to describe best practice of public disclosure requirements about technical performance and risks that should apply to non-life insurers and reinsurers.[1] Whereas international accounting standards (IFRS/IAS) draw up general accounting principles, which are appropriate to undertakings of all sectors, this standard is only concerned with insurers and consequently describes best practice for insurers in greater detail. This is necessary as market participants[2] are better able to assess the performance of and risks taken by insurers when adequate information is provided. Public disclosure can assist them in responding in an appropriate manner, providing an element of market discipline that can support the supervisory process.

This standard should be seen together with:

- the IAIS *Insurance core principles and methodology* (October 2003) (ICPs), in particular ICP 26 - Information, disclosure and transparency towards the market - and the related criteria
- the IAIS *Guidance paper on public disclosure by insurers* (January 2002) that contains general guidance on public disclosure.

As described in the guidance paper, disclosures must be relevant, timely, accessible, comprehensive, reliable, comparable and consistent. At the same time, the costs of increased disclosure and competitive disadvantage must be weighed against its potential benefits in setting disclosure requirements.

This standard sets out specific requirements on what to disclose to facilitate the assessment of technical performance and risks of insurers and how to disclose it. Both retrospective disclosures and prospective disclosures should be given.

The standard also describes the role of the supervisor in enhancing disclosure by insurers. It does not, however, require supervisors to disclose information obtained when carrying out their duties.

This standard does not address disclosures in other areas such as market risk, liquidity risk and operational risk, which will be covered in future papers. However the standard will be

1 This standard applies to captives if they are considered insurers or reinsurers in the legislation of the jurisdiction. Supervisors can decide not to apply this standard to "captives" that are considered non-life insurers or reinsurers in the legislation in the jurisdiction, provided there is no potential threat to the financial system, no public interest need for disclosure and no legitimately interested party is prevented from receiving information. For the purpose of this standard, "captive" shall mean an insurance or reinsurance entity created and owned by one or several industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, and only a small part, if any, of its risk exposure is related to providing insurance or reinsurance to other parties.

2 Market participants include policyholders, direct insurers, shareholders, equity analysts, insurance agents and brokers, rating agencies, and the news media.

reviewed and revised as required, to reflect evolving best practices.[3] Taking into account priorities identified by the IAIS Technical Committee and the Multi-disciplinary Working Group on Enhanced Disclosure, this standard is to be complemented by a future IAIS standard on disclosures concerning investment performance for non-life and life insurers. Later, a standard on technical performance and risks for life insurers is envisaged.

Contents

1. General requirements

1. Insurers should provide qualitative and quantitative information on technical performance and risks.

2. Insurers should publicly disclose information on technical performance and risks that is:

- relevant to decisions taken by market participants (policyholders, cedents, investors etc.)
- timely so as to be available and up-to-date at the time those decisions are made
- accessible without undue expense or delay by the market participants
- comprehensive and meaningful
- reliable as a basis upon which to make decisions
- comparable between different insurers
- consistent over time so as to enable relevant trends to be discerned.

3. These attributes are expanded upon in the *Guidance paper on public disclosure by insurers* (January 2002). In addition, the Guidance Paper explains that meaningful comparisons can only be made where there is adequate disclosure of how information is prepared.

3 In developing this standard, the IAIS has taken account of the work of the International Accounting Standards Board (IASB). The standard is not intended to contradict the IASB requirements and in light of this, will be reviewed once the IASB's work in this area is completed.

2. Role of supervisors

4. Market discipline is an adjunct to supervision. However, in order to exercise this discipline effectively, market participants need relevant information on the technical performance and risks of insurers.

5. The supervisory authority should, therefore, assure that effective disclosure requirements are in place.

6. Where supervisors are standard setters, they should set disclosure requirements consistent with this standard.[4] Where this is not the case, supervisors should encourage standard setters to set disclosure requirements about technical performance and risks consistent with this standard.

3. Disclosures by classes

7. Disclosures in paragraphs 11-18 and 20-32 should be provided by business classes. This helps market participants understand the contribution of individual classes to the technical performance and risks of the insurer.

8. For entities in which non-life insurance business makes up a significant part of the total business, disclosures should at least be provided for the following classes if they are significant:[5]

i) Motor insurance
ii) Marine, aviation and transport insurance (including freight)
iii) Fire and other property damage
iv) Credit insurance and suretyship
v) Liability insurance
vi) Accident and health insurance
vii) Other non-life insurance[6]
viii) Non-proportional reinsurance treaties.

9. Classes i) to vii) should include proportional treaties and facultative reinsurance.

10. Policies combining different risks should be classified according to the most important risk.

4 The supervisor should determine whether transitional arrangements are necessary in a jurisdiction, but should encourage full compliance with this standard by all insurers.

5 Supervisors may wish to provide guidance as to what constitutes significant, for example, a minimum 5% of earned premiums or claims incurred.

6 Insignificant classes should be merged with this class.

4. Analysis of technical performance

11. Insurers should provide information on their objectives and policies for underwriting insurance risks that is consistent with how the risks are managed (including information on the models and techniques that management uses to manage those risks).

12. An insurer should provide qualitative and quantitative information on technical performance in the areas of pricing adequacy, provision adequacy, claims statistics, risk concentrations, reinsurance and capital. Note that the analysis of performance is inherently backward looking, but it is the experiences of the past – the historical data – that are the major foundation on which the assessment of future risks are based.

Pricing adequacy

13. In order to judge how well insurance premiums cover the underlying risk of the insurance contracts and the administration expenses of the insurer (pricing adequacy), an insurer should disclose data on:

- loss ratio
- expense ratio
- combined ratio
- operating ratio.

14. These ratios should be calculated from the profit and loss account of the reporting year and should be gross of reinsurance in order to neutralize the effect of mitigation tools on the technical performance of the direct business. Gains on reinsurance cannot be expected to continue indefinitely without price adjustments from reinsurers. Disclosure on reinsurance is described below. If the net ratios are materially different from the gross ratios, then both ratios should be disclosed. The ratios should be measured either on an accident year or an underwriting year basis.

15. The **loss (or claims) ratio**[7] - the ratio of claims incurred to premiums earned - gives an indication of how well the pricing of an insurer matches the risks taken in the insurance contracts.

16. The **expense ratio** is the ratio of expenses to premiums earned, where expenses are the sum of commissions, administrative expenses and other technical charges.[8] It can be used to assess how well premiums cover expenses incurred.

17. The **combined ratio** - the sum of the loss ratio (claims ratio) and the expense ratio - gives a rough indication of the profitability of an insurer's underwriting operations. It does not, however, take into account the allocated investment return except to the extent that discounting takes into account future interest rates. Since income from invested premiums also contributes to technical performance, the business can be profitable even if the combined ratio exceeds 100%. The combined ratio is, amongst other factors, a function of

7 The figure stated in the profit and loss account includes the adjustment for claims incurred in previous years. In order to give a more complete view on pricing adequacy it is necessary to also consider the information requested in paragraphs 24-25.

8 This ratio could vary depending on the way an insurer allocates its general costs.

the period of time premiums are invested and the return on investments. Furthermore, the characteristics of the class of business in question, that is, the uncertainties concerning a particular class of business (volatility of losses, legal framework, the time to re-establish surplus etc.) can influence the combined ratio.

18. The **operating ratio**[9] is the combined ratio adjusted by the addition of allocated investment return in relation to premium income. This ratio enables the assessment of business performance after inclusion of allocated investment return.

19. When discounting is used, information on the discount rates used and method of discounting should be provided. The discount rates should be disclosed at an appropriate level of aggregation by duration as follows:

- for each of the next five years
- average rate for claims expected to be paid after five years.

20. Insurers should disclose the ratios, accompanied by supporting narrative, over several years to enable market participants to better evaluate long term trends. Ratios relating to previous years should not be recalculated to take into account present information. The length of the time period should reflect the historical volatility of the particular class of insurance business.

Provision adequacy

21. In order to enable market participants to evaluate trends, insurers should disclose historical data about earned premiums compared to technical provisions by class of business. To assess the adequacy of technical provisions, insurers should disclose historical data on:
- the run off result
- claims development.

22. To facilitate the evaluation of an insurer's ability to assess the size of the commitments to indemnify losses covered by the insurance contracts issued, insurers should disclose historical data on the results of the run off of technical provisions set aside in previous accounts.

23. Technical provisions can be divided in two: one part that covers claims from insurance events which have already taken place at the date of reporting (claims provisions including IBNR provisions[10] and IBNER provisions[11]) and another part that should cover losses from insurance events which will take place in the future (the sum of provision for unearned premiums and provision for unexpired risks also termed premium deficiency reserve). Insurers should provide information on the run off results defined below for each part of the technical provisions.

9 If the operating ratio exceeds 100%, losses (claims incurred) and expenses exceed premium income and allocated investment return, thereby contributing negatively to the overall return on invested capital.

10 Provisions for claims incurred but not reported by the balance-sheet date.

11 Additional provisions for claims incurred but for which not enough has been reserved.

24. The **run off result** in relation to **provisions for incurred losses** is the difference between:

- the claims provisions made at the beginning of the financial year, and
- the sum of the payments made during the year on account of claims incurred in previous years and the claims provisions shown at the end of the year for such outstanding claims.

25. The **run off result** in relation to **provisions for future losses** is the difference between:

- the sum of provision for unearned premiums and provision for unexpired risks made at the beginning of the year, and
- an evaluation of the payments made during the year and provisions made at the end of the year, in both cases relating to insurance events covered by the unearned premiums at the beginning of the year.

26. The run off results should also be disclosed as a ratio of the initial provisions for the losses in question. When discounting is used, the effect of discounting should be shown separately.

27. Insurers should disclose the run off results over several years to enable market participants to evaluate long-term patterns; for example, how well the insurer estimates the technical provisions. The length of the time period should reflect how long-tailed the distribution of losses is for the insurance classes in question.

28. Except for short-tail business,[12] insurers should disclose information on the development of claims in a claims development triangle. The **claims development triangle** shows the insurer's estimate of the cost of claims (claims provisions and claims paid) as of the end of each year and how this estimate develops over time. This information should be reported consistently on an accident year or underwriting year basis and should reconcile to amounts reported in the balance sheet.

12 Short-tail business is defined as: when all claims are expected to be settled no later than one year after the accident year.

Example: Claims development triangle

This example illustrates a possible format for a claims development triangle.

Accident year	1997	1998	1999	2000	2001	
Claims provisions and claims paid at the end of the accident year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
						Total
Estimate of cumulative claims	702	771	845	903	968	
Cumulative payments	(650)	(689)	(570)	(350)	(217)	
Claims provisions (undiscounted)	52	82	275	553	751	1,713
Earned premiums	822	933	1,052	1,123	1,215	
When discounting is used:						
Effect of discounting	(5)	(14)	(68)	(175)	(285)	(547)
Present value recognised in the balance sheet	47	68	207	378	466	1,166

29. As with the pricing adequacy ratios, provision adequacy should be calculated gross of reinsurance and be supported by an accompanying narrative.

Claims statistics

30. For high volume, homogeneous classes, direct insurers should disclose statistical information on claims. For instance, they should describe the trend in the number of claims and the average size of claims. To be relevant, this information needs to be linked to the level of business: number of policies, earned premiums, etc.

31. Ideally, the trend in claims should reflect the development in insurance risks. As it is difficult to point to one good measurement method of insurance risk, several can be considered but, at a minimum, insurers should disclose historical data accompanied by supporting narrative on:

- the mean cost of claims incurred – i.e., the ratio of the total cost of claims incurred to the number of claims – in the accounting period by class of business (classes are described in paragraph 8)
- claims frequency - for example, the ratio of the number of claims incurred in the reporting period to the average number of insurance contracts in existence during the period

32. For non-homogeneous classes, qualitative information will suffice.

Risk concentrations

33. Insurers should disclose information on risk concentrations.[13] A risk concentration refers to an exposure with the potential to produce losses large enough to threaten an insurer's economic health or ability to maintain core operations.

34. Insurers should disclose information on risk concentrations that includes:

- a qualitative and quantitative description of the kinds of risk concentrations to which the insurer is exposed and how high these are (including a description of the methods used and assumptions made in arriving at the quantitative data). If it is not possible to provide quantitative data, it should be explained why it is not possible
- a description of the extent to which the risk is reduced by reinsurance and other risk mitigating elements.

35. The description of the insurer's risk concentrations should, as a minimum, include information on the geographical concentration of insurance risk, the economic sectoral concentration of insurance risk, and if relevant, the risk concentration inherent in the reinsurance cover (see also paragraphs 43-44).

36. As a minimum, the geographical concentration of premiums[14] should be disclosed. The geographical concentration should be based on where the insured risk geographically is located, rather than where the business is written. Insurers should disclose premiums based on the geographical location of the insured risk. If this is not possible, the geographical concentration could be based on where the business is written.

37. As a minimum, the sectoral concentration of premiums should be disclosed. Insurers could additionally disclose the economic sectoral concentration based on other indicators of risk, such as sum of insured's or the coverage amount provided.

38. Insurers should disclose information on the risk concentration inherent in the reinsurance cover. As a minimum, insurers should disclose the number of reinsurers that it engages, as well as top-five concentration ratios. As a minimum, insurers should disclose the top-five-premium concentration ratio, which shows the premiums ceded to an insurer's five largest reinsurers in aggregate, as a ratio of the total reinsurance premium ceded.

39. Insurers should consider which other concentrations, in addition to those mentioned in the minimum requirements above, should also be disclosed.

Reinsurance and other risk mitigation

40. Insurers should provide information on their objectives, policies and practices for retaining and mitigating insurance risks.

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13 Risk concentrations can arise, for example, from: exposure to extreme events (i.e., low-frequency, high-severity risks such as earthquakes, concentrated exposure from a single contract, or class of related contracts, or concentrated exposure from different classes of insurance contracts); concentration of policyholders based on geographical location or industry; exposure to significant litigation risks (e.g., concentrated exposure from a large single insurance contract, or from a pervasive effect on many insurance contracts)

14 The disclosure should be based on earned premiums, or written premiums, whichever is used for revenue recognition purposes in the financial reporting of the jurisdiction.

41. Insurers should provide information about reinsurance and other risk mitigation tools.

42. Insurers should provide information on the adequacy of their reinsurance cover, how reinsurance is obtained,[15] information on their reinsurers and on the credit risk of the reinsurance cover.

43. Since reinsurance programs are often very complex and highly individual, quantitative data should be supplemented by qualitative information. A description of the insurer's overall reinsurance cover should be disclosed explaining the net risk retained and the types of reinsurance arrangements made (treaty, facultative, proportional or non-proportional) as well as any risk mitigating devices that reduce the risks arising out of the reinsurance cover. The reinsurance result – the cost of reinsurance less recovery from reinsurance of incurred claims – should be disclosed. The cost of reinsurance should include reinsurance premiums as well as foregone investment return from these reinsurance premiums.

44. The insurer should disclose the total amount of reinsurance assets included in the balance sheet,[16] showing separately the reinsurers' share of technical provisions and receivables from reinsurers on settled claims. Further quantitative information on reinsurance should be given including:

- the credit quality of the reinsurers, for example, by grouping reinsurance assets by credit rating
- credit risk concentration of reinsurance assets
- the proportion of the reinsurers that are supervised
- the nature and amount of collateral held against reinsurance assets
- the development of reinsurance assets over time
- the ageing of receivables from reinsurers on settled claims.

Capital

45. Information on capital adequacy in relation to solvency requirements should be disclosed; in particular, the generic solvency requirements of the jurisdiction and how insurers comply with the requirements. Insurers should also disclose the components of regulatory capital according to its quality; for example, by showing the amount of common shares, preferred shares, subordinated debt, etc.

46. Since there is currently no international capital standard for insurers, this disclosure does not lend itself to cross-border comparisons. It is mainly relevant to analysing trends within an individual insurer.

47. Insurers should at least disclose historical data on a company level on:

- the ratio of regulatory capital to premium income
- the ratio of regulatory capital to losses
- the ratio of regulatory capital to technical provisions.

15 For instance, whether reinsurance is obtained through brokers or directly.

16 Reinsurance assets include receivables from reinsurers on settled claims and the reinsurer's share of the technical provisions.

5. Key assumptions and sources of measurement uncertainty

48. To enhance transparency and comparability, insurers should disclose key assumptions and methodologies used in measuring insurance assets and liabilities and in the development of financial information required by this standard. An insurer should indicate the level of uncertainty association with the reported amounts, to allow the users to judge whether estimates are likely to fall within a wider or a narrower range. Where relevant, this information should include:

- key assumptions about market variables, such as the rates of inflation
- key assumptions on entity-specific variables, such as claim rates, claim severity etc.
- the main sources of data used and the chief elements of methodologies applied in measuring insurance assets and insurance liabilities
- significant correlations between different assumptions
- the main factors considered when calculating adjustments to the value of insurance assets and insurance liabilities to reflect risk and uncertainty
- significant pending matters that may cause a reassessment of the value of the insurance assets and liabilities reported (for example changes in legislation or court rulings)
- other significant assumptions considered in measuring insurance assets and liabilities.

6. Sensitivity, stress testing and scenario analysis[17]

49. Stress testing and scenario analysis performed by the insurer should reflect the insurer's unique risk profile. A broad outline of the nature of the tests that have been undertaken and how the results are used should be disclosed.

50. Public disclosure of the actual financial results of the stress test scenarios might assist users to assess an insurer's ability to withstand adversity. On the other hand, stress testing is a key management tool to help insurers understand the consequences of adverse situations. Stress testing might not achieve this key objective if insurers were required to publicly disclose the actual stress test results. For this reason, this standard does not require such disclosure.

51. Insurers should disclose sensitivity tests in order to enable market participants to evaluate and compare the uncertainties inherent in the accounts, the exposure to risk, and their impact on the financial position and economic performance.

52. Disclosure of sensitivity analysis on technical performance and risks is meant to provide the impact of a minor change in one of the underlying assumptions or variables.

53. Insurers should disclose quantitative and qualitative information about the sensitivity of their reported financial information to changes in variables that have a material effect on them. Insurers should describe the analysis performed and explain the results of the sensitivity analysis and any other aspects that may enhance the understanding of the results,

17 Refer to the IAIS Guidance paper on stress testing by insurers (October 2003) for a description of sensitivity, stress testing and scenario analysis.

including non-linearities (such as stop-loss or excess of loss features). As a minimum, insurers should disclose the results of the following standardised sensitivity analyses:

- the effects on profit or loss and equity of a change[18] in average claim size of 1 percent
- the effects on insurance liabilities of a 10% change in the rate of inflation
- the effects on assets of a 10% change in the rate of interest[19]
- if discounting is used, the effects on insurance liabilities of a 10% change in the rate of interest used for discounting.

54. This does not preclude supervisors from requiring more sophisticated sensitivity analysis.

55. If the sensitivity tests in paragraph 53 are inappropriate or misleading given particular market conditions in a market, the supervisory authority of insurers conducting business in that market could consent to another selection of standardised sensitivity tests.

18 A change refers to a relative change, both an increase and a decrease, for example, if the rate is 4% (.04), a 10% change would be 0.4 % (.004).

19 The sensitivity analysis related to the investment performance will be further addressed in the forthcoming standard on investment performance and risks.

Guidance Paper No. 1

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE ON INSURANCE REGULATION AND SUPERVISION FOR EMERGING MARKET ECONOMIES

September 1997

Guidance on Insurance Regulation and Supervision for Emerging Market Economies Report from IAIS Emerging Market Issues Committee

Contents

I. General Introduction

The attached paper was prepared by the Emerging Markets Issues Committee of the IAIS. The aim of this paper is to promote the establishment, adoption and implementation of regulatory and supervisory guidance for insurance markets in emerging economies. The guidance describes the unique challenges specific to emerging market economies and specifies the measures to be taken in order to move from the current regulatory regimes to ones meeting the level of supervision described in the IAIS Insurance Standards, which are being prepared by the Technical Committee.

The paper consists of three main parts:

- roots of problems in insurance markets in emerging economies (general characteristics of insurance markets in emerging economies);
- measures to solve problems (guidance for sound insurance systems); and

- action plans (plans for implementing essential measures for insurance markets in emerging markets).

Some parts of the paper refer to the concepts and terminology used by the report of the G-10 Working Party on financial stability in emerging market economies; the twenty insurance guidelines for economies in transition (adopted at the Second East West OECD Conference on insurance organised in cooperation with the Polish government in Warsaw in April 1997), their related notes and Mr. Bellando's note distributed during the conference have provided important information.

II. Draft guidance on insurance regulation and supervision for emerging market economies

1. Background

This guidance was prepared on the basis of the discussion and conclusion in the Emerging Market Issues Committee held in February and May in 1997. As discussed in the meetings, insurance markets in emerging market economies have faced unique challenges as have other financial sectors in the economies. Instability of financial markets, including the insurance sector in emerging market economies could have an impact on global financial markets. Indeed, lack of clear guidance to foster sound insurance markets for the emerging market economies has slowed the reform of the insurance sector and aggravated their problems. Thus the Emerging Market Issues Committee and Education Committee of the IAIS, because of their unique role in the international insurance supervisors' society, decided to prepare guidance on insurance regulation and supervision for emerging market economies.

2. Aim and main contents

The aim of this paper is to promote the establishment, adoption and implementation of regulatory and supervisory guidance for insurance markets in emerging economies that will assist in establishing a sound and reliable insurance system. The guidance is intended for insurance supervisors of emerging market economies.

Draft guidelines on insurance supervision applicable to all insurance markets (the IAIS Insurance Standards) are presently being discussed by the Technical Committee of the IAIS. The guidance presented here describes the unique challenges specific to emerging market economies and specifies the general measures that can be taken in order to move from the current regulatory regimes to others that are settled in the IAIS Insurance Standards and that can improve their actual situation. In other words, the guidance is intended to confirm the principles of basic regulatory and supervisory issues and to indicate clearly a route for reaching the level of supervision of IAIS Insurance Standards, covering crucial issues for the stability of insurance markets in emerging market economies.

Without specific action, establishing principles and preparing guidance do not have any impact on the real market. Thus, the paper proposes at the end a strategy (action plan) to promote the development and implementation of the described measures in emerging market economies.

3. Premises

In order to achieve its aim, this report has been guided by the fundamental premises set out below:

1. Sound macroeconomic and structural policies are essential for insurance system stability in order to prevent or at least limit the emergence of serious market distortions. Without the stability of the economy as a whole and sound development of basic financial and legal infrastructure such as the banking, credit and tax systems, the sound development of the insurance industry will not be achieved. There must also be sufficient political and social consensus supporting the measures needed to establish and maintain sound insurance markets.

2. Ultimate responsibility for the policies chosen to strengthen insurance systems must lie with the national supervisors or regulators who have a strong interest in developing sound arrangements for these systems.

3. Insurance sector stability is only achieved when prudential standards are met and when markets operate competitively, professionally and transparently in an international environment, according to sound principles and practices that generate the relevant information and appropriate incentives.

4. The strengthening of the regulation and supervision framework in parallel with the slow and cautious introduction of liberalisation measures is essential for improving the efficiency of the insurance market. Liberalisation without attendant prudential regulations and supervisory measures merely fosters chaotic market situations. Emerging market economies need special consideration in this regard due to their particular economic and financial situations.

5. Although reforms are in many cases urgently required, it must be realised that insurance markets in emerging market economies differ widely from one another. It is indispensable that insurance system reform take into account the particular character of each country and be appropriately adapted. In addition, regulatory and supervisory frameworks have to be adapted on a regular basis in order to match changing conditions, perceptions and economic needs.

4. General characteristics of insurance markets in emerging economies

The instability of the insurance sector in emerging market economies can be attributed to a wide range of microeconomic and institutional failings. However, it is almost invariably in an unstable macroeconomic environment such as a high inflation rate, in the wake of major structural

transformations or as a result of serious distortions in the real economy, that these failings give way to more critical problems.

In general, problems begin with lax management within insurance companies. Poor internal controls and moral hazard, where owners lack the proper incentives to act prudently and to supervise managers, often cause institutional failures. A particular case in this regard may be that of state owned companies, where managers may be guided by objectives that are not compatible with sound financial practices, while at the same time they are shielded from any external discipline. Weaknesses in the legal framework compound the problems of lax management and weak corporate governance.

The market can play a crucial role in disciplining bad performers, but this function may not be performed satisfactorily in the presence of inadequate information or distorted incentives. Some of the governments in emerging market economies also tend to be very cautious to expose the insurance sector to market discipline.

Basic infrastructure shortcomings for establishment and maintenance of a sound insurance system (accounting systems, financial markets as well as a legislative framework) can aggravate matters by failing to identify problems and preventing them from being addressed in a comprehensive and timely manner.

Strong regulatory and supervisory arrangements (insurance supervisory authorities, prudential regulations) that complement and support the operation of market discipline are indispensable to the stability of insurance markets. However, in the absence of effective market discipline, the entire burden of external control falls on insurance supervisors who may not have the requisite capacity.

The crucial issue for a robust insurance system is the development of a capable, professional cadre of insurers and supervisors. However, basic manuals for this purpose, particularly for training manuals for supervisors, have not yet been properly developed and training programmes are often not systematically arranged.

5. Guidance for sound insurance systems in emerging market economies

5.1 Creation of the essential infrastructure for effective market functioning

5.1.1 Legislation

Insurance legislation is essential to establish a sound and robust insurance system. Other legislation indispensable to the insurance sector such as commercial code, civil code, company law, tax law, banking law, should also be established at the same time. A legal environment should be fostered in any case. High quality insurance regulations and standards assure market participants that sound practices are being applied, thereby increasing market transparency and confidence. Although all

economies should periodically revise and update legislation to meet new market realities, emerging market economies face a particular challenge in developing a legal system suitable to a market environment, given the rapidly changing economic conditions and in some cases, the heritage of extensive state involvement in economic decisions. Frameworks based on industrial country models have proved useful but must still be adapted to the particular environment of emerging market economies and altered as those systems evolve.

A comprehensive set of prudential regulations and standards is indispensable if insurance supervisory authorities are to exercise their powers and responsibilities in a coherent fashion. The regulations and standards should be objective, internally consistent, transparent and clearly understood by those to whom they are applied.

5.1.2 Accounting principles and the role of actuaries and auditors

Accounting systems are central to the provision of the information needed by investors, consumers, managers, supervisors and other interested parties with an actual or potential stake in an enterprise so that they can make reasonable assessments of the effectiveness of the enterprise's operations and assess its future prospects. High quality accounting systems, taking into account the particular nature of the insurance sector, provide authorities with the practical means to perform proper audits, while at the same time are a vital resource for the management of companies and other interested parties. Indeed, insurance legislation can only play its intended role where effective information exists for its enforcement. Ensuring that the supervisory authorities have regular access to reliable information about insurance companies is a crucial issue for emerging markets since a lack of this mechanism have often delayed the discovery of financial problems in insurance companies and has therefore failed to prevent many of them going bankrupt.

Accounting methods should provide a real picture of economic gains and losses. The accounting system should establish rules that are to be applied uniformly to all insurance companies and are compatible with internationally accepted accounting standards. Not only should each accounting item be clearly defined but also the precise evaluation method should be stated in the regulations so that the financial condition of a company can be disclosed without any ambiguity. The information provided should be accurate, relevant and transparent. The information should also be comprehensive, timely and provided to the relevant parties on a regular basis.

Auditing provided by chartered accountants, independent, officially recognised and with a deontology code is vital to ensuring that accounting norms for insurance businesses are effectively applied and maintained, and to monitor the quality of internal control procedures. Internal auditing is vital to monitor the quality of internal control procedures. An actuarial system might be established that covers at a minimum, valuation of the liabilities of life insurance businesses, valuation of the assets corresponding to liabilities and the amount of the required solvency margin of life insurance businesses. Both internal and external audits are necessary and these constitute important complements to the assessment of insurance companies by the insurance supervisor.

5.1.3 Reliable data base

Availability of reliable basic data is also essential for effective market discipline. In particular, insurance premiums are calculated on the basis of the law of large numbers. For this reason, establishment of reliable policy data such as loss frequency and loss severity is indispensable in calculating correct insurance premiums and the technical provisions that are crucial for maintaining the solvency of insurance companies and for establishing the stability of insurance markets. Reliable mortality tables are also essential for life insurance products. In many cases of emerging market economies, an insurance company does not have enough past insurance policies to create a reliable data basis or a data collecting system itself has not yet been properly established. Thus the collection of claims data through cooperation of insurers should be encouraged. The insurance supervisory authorities should also establish a reliable claims database that will help insurers and supervisors confirm the right price for various categories of products.

5.2 Creation of the insurance supervisory authority

5.2.1 Creation of the insurance supervisory authority

Insurance legislation and reliable information can play their proper role only if an enforcement body i.e., an insurance supervisory body is established and functions effectively.

Therefore, the insurance supervisory authority should:

- have the power to license insurance companies, apply prudential regulations, conduct consolidated supervision, obtain and independently verify relevant information, engage in remedial action and execute portfolio transfer, and apply sanctions against insurance companies which do not follow the recommendations and injunctions of the supervisory authorities (i.e., restrict the business activities of a company, direct a company to stop practices that are unsafe or unsound or take action to remedy an unsafe or unsound business practice with the option to invoke other sanctions on a company or any business operation);

- be independent from both political authorities and controlled companies in the daily execution of supervisory tasks and be accountable in the use of its powers and resources to pursue clearly defined objectives;

- have broad and ample knowledge and experience ranging from actuarial science to contract law drawn from wide experience;

- have a reliable and stable source of funding to safeguard its independence and effectiveness;

- have the powers and sufficient resources to co-operate and exchange information with other authorities both at home and abroad thereby supporting consolidated supervision; and

- establish an employment system to hire, train and maintain a professionally qualified staff.

At the same time, the insurance supervisory authority must be bound to strict professional secrecy and the legislation must exclude any arbitrary intervention of the administration. Except the cases stipulated in law, the insurance supervisor may under no circumstances interfere in the management of insurance companies: the company's management being the only party liable for the decision it makes within the framework of the mandate conferred upon it by the owners of the company.

The supervisory authority should establish good cooperation and co-ordination schemes with other related government bodies or insurance institutions, such as ministries, tax offices or insurance guaranteed funds so that the given tasks are properly carried out.

5.2.2 Private market arrangements

The insurance industry should be encouraged to set up private mechanisms and institutions for the application of business guidelines and a code of conduct to limit detrimental practices. Self-regulatory principles and organisations, including professional bodies can be a useful complement to the public supervisory structure. However, supervisory authorities need to scrutinise such arrangements in order to ensure that they promote effective market functioning.

5.3 Promotion of the market mechanism

5.3.1 Information disclosure

It is important to improve the quality, timeliness and relevance of standards for disclosure of key information needed for credit and investment decisions in the interest of stakeholders (interested parties). Ensuring information disclosure is also essential for consumers to be able to select appropriate insurance products from the right insurance company. The most important information concerns the financial condition of an insurance company, the nature of its insurance products and the character of an insurance intermediary.

5.3.2 Foundations for good institutional governance

The foundation for good institutional governance is sound business strategy along with competent and responsible management. Insurance companies should be encouraged to develop an ownership structure that fosters stakeholder oversight. Private ownership of insurance companies is essential for strengthening the monitoring of management performance and reducing distortions in incentives and avoiding political interference in management. Privatised insurance companies should be established on a sound financial basis and with diverse ownership.

Good institutional governance of insurance companies requires comprehensive internal control procedures and policies that are implemented by skilled personnel and carefully monitored by management. Even capable management is liable to commit errors in fulfilment of its duties. Thus effective risk management of insurance companies is crucial. Insurance companies should have effective means to measure, monitor and control the various risks they face.

5.3.3 Promotion of competitiveness that is subject to essential prudential safeguards

Reforms leading to a market economy, particularly competition and liberalisation measures, are expected to promote entrepreneurial freedom, responsibility and accountability, optimise allocation of resources, increase efficiency and bring a better match between supply and demand and ultimately better quality services at reasonable prices. Subject to prudential regulations and supervision being met, competition in the insurance sector should be fostered by removing unnecessary restrictions and allowing participation of sound insurance companies in the insurance market. In particular, establishment of foreign insurance companies should be based on prudential but non-discriminatory rules.

5.4 Prudential supervisory and regulatory measures

Due to the high risk (insurance risk, investment risk, credit risk) environments in emerging market economies combined with limited experience and expertise, prudential regulations should be given particular emphasis.

5.4.1 Licensing and changes in control

Starting an insurance business requires a considerable amount of capital, special expertise, reliable management and an elaborate business strategy. For this reason, in most jurisdictions, it is a legislative requirement that those companies wishing to transact business in the domestic insurance market be licensed. In effect, licensing control is the main supervisory means by which unsound insurance companies are prevented from entering the market. This means that supervisory authorities can concentrate more on preventive measures against any financial difficulties rather than spend considerable energy and time dealing with insurance companies that are in trouble.

In emerging market economies, lax licensing control often allows undercapitalised and poorly managed insurance companies to enter the market and subsequently suffer from financial problems. Therefore, sufficiently strict licensing criteria should in particular govern the establishment of insurance companies. Examination of the nature and adequacy of the financial resources of insurance companies through analysis of business plans and the requirement for a relevant minimum level of capital deserves particular consideration. The supervisor should also consider the suitability of owners, directors and/or senior management. The insurance supervisor should also review changes in the control of companies and establish clear requirements to be met when a change in control occurs. These may be the same as or similar to the requirements which apply in granting a license.

The underwriting of insurance risks should be restricted to insurance companies which may transact insurance operations only. Life and non-life insurance operations should be separated, so that one activity cannot be required to support the other. Reinsurance companies and direct insurance companies should also be separated at the initial stage in emerging market economies.

5.4.2 Ongoing supervision

a. Practice on supervision, in particular on-site inspection

Insurance supervision should be exercised over the entire operations of the insurance company undergoing control and should involve various aspects, such as moral, legal, technical and financial. The insurance supervisor should in particular ensure that insurance companies are observing the regulations applicable to insurance. More specifically, the insurance supervisor should ensure that insurance companies:

- meet the contractual commitments made toward the insured (legal control); and
- are at all times in a sound financial position so as to meet their commitments (solvency control).

In order to achieve this, the insurance supervisor should examine not only the financial position of an insurance company at a given moment but also its operating conditions that determine its future financial position. Indeed the aim of insurance supervision is not to check whether a company was solvent at the date of its last financial report but to assess its ability to meet its commitments in the future.

In order to conduct the preventive control, regular contact with insurance management and thorough understanding of the insurer's operations are essential. There must be a means for independently and reliably verifying information reported or disclosed, in particular, the adequacy of technical provisions and asset valuations. On-site inspections are particularly important in allowing a supervisory authority to evaluate a management's effectiveness and its compliance with supervisory standards in those markets where weaknesses in accounting or reporting systems impair the effectiveness of off-site inspections. On-site inspection and off-site inspection of the same company should in principle be performed by the same person or group so as to ensure rational use of the information provided and supervisory powers. On-site inspections should cover all the factors which may sooner or later have an impact on the performance of the insurance company and thus on its financial position, i.e., control over the sales network, rating system policy, follow-up of claims and of results, risk selection, administrative organisation, financial management, efficiency of reinsurance, internal control, etc. These observations are essential in the assessment both of the skills and efficiency of the managers of an insurance company and of its capital requirements. A certain reliance could be placed on external auditors or actuaries only if a well developed auditing and actuarial profession exists and where auditors and actuaries are fully accountable.

b. Liabilities

The setting aside of liability, particularly technical (mathematical) provisions in an amount sufficient to meet at all times the company's commitments vis-à-vis the insured is at the very core of insurance business. However, calculating the proper level of technical provisions is indeed a challenge both for the insurance companies and for the insurance supervisor in emerging market economies. Inadequacy of technical provisions often cause financial difficulties or insolvency of insurance companies.

Inadequacy of technical provisions may be due to several factors: lack of legislative and practical measures on technical provisions, lack of historical data, uncertain economic conditions particularly a high inflation rate, an inadequate premium rate and a lack of professionals such as actuaries and auditors.

Introduction of appropriate legislation and monitoring measures is the first step to be taken. Insurance supervisors should establish standards with respect to the liabilities of companies. In developing the standards, the insurance supervisor should consider:

- what is to be included as a liability of the company, for example, claims incurred but not paid, claims incurred but not reported, amounts owed to others, amounts owed that are in dispute, premiums received in advance, as well as the provision for policy liabilities or technical provisions that may be set by an actuary;

- the standards for establishing policy liabilities or technical provisions; and

- the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements, making provision for the ultimate collectability.

In addition, the accumulation of expertise both in supervisory authorities and in insurance companies should be encouraged. Data should be established that help evaluate sufficiency of technical provisions. The technical interest rate should be regulated in proportion to the general economic situation. The supervisor should monitor premium levels in order to avoid under-priced products. Professionals such as actuaries and auditors should be encouraged to be developed.

c. Assets

Technical provisions must at all times be backed up by equivalent assets that belong in full to the insurance company and are set aside to guarantee its commitments. Policyholders should have a preferential claim on the assets of the insurer in case of liquidation. In order to ensure the safety , profitability and liquidity of its investments, the insurance company must ensure that its investments are sufficiently diversified and dispersed.

Emerging market economies often suffer from limited investment opportunities, highly volatile capital markets, limited investment management and unadapted evaluation measures. Information on the financial markets is often not transparent. In addition, where stakeholder discipline mechanisms are poorly developed, competition is limited or historical circumstances have retarded the development of strong risk management as an institutional governance priority, the regulatory framework needs to pay special attention to insurance companies' procedures for assessing and managing all risks including credit risk (exposure to loss as a result of default on an instrument) and market risk (exposure to price change).

Prudential investment rules should be implemented that take into account the reality of markets. Insurance supervisors should establish standards with respect to the assets of insurance companies. These standards should address:

- diversification by type;
- any limits or restrictions on the amount that may be invested in financial instruments, property and receivables;
- the basis for valuing assets which are included in the financial reports;
- the manner in which those assets are held, such as self keeping assets; and
- appropriate matching and liquidity.

In addition, admissibility of the value placed on assets for the backing up of technical provisions by equivalent assets, or solvency margin requirements may be stated in regulations. It would also be appropriate for the value of unlisted assets and real estate to be certified by independent professionals.

Investment regulations on insurance should be co-ordinated with the regulations in other financial sectors so that they do not unbalance competition and hold back the sound development of the whole financial sector.

Emerging market economies tend to adopt highly restrictive rules on investment abroad. This is understandable for countries which have severe foreign currency reserve constraints. Also it is appropriate to follow the principle of currency matching in order to ensure protection from exchange rate risks. On the other hand, investments abroad can provide access to a healthy diversified portfolio and long-term investments tool, which are sometimes difficult to find in emerging market economies. Since fostering national investments also helps to finance the national economy, and on the other hand, investments abroad may reduce the risk linked to the inflation rate, then the investment policy abroad should be gradually liberalised at the same time as prudential regulations are introduced.

d. Capital adequacy

Both in the licensing process and in ongoing supervision, the insurance supervisor needs to pay particular attention to capital adequacy. The capital base (solvency margin) means the financial sources (margin) that work as a buffer against the possible adverse development of liabilities and other adverse circumstances such as changes in the litigation system, unexpected expense overruns, etc. Thus it provides information on the financial standing of the company and alerts supervisors to take any necessary action to protect policyholders. The requirements regarding the capital to be maintained by insurance companies should be clearly defined and address:

- minimum levels of capital or the levels of deposits (these levels concern only local branches of foreign insurers) that should be maintained. Capital adequacy requirements should reflect the size and business risks of the insurance company; and
- the process for valuing capital should reflect the requirements for valuing both assets and liabilities

The capital base is only an instrument for measuring and monitoring solvency. It should not be deemed by the management or the supervisor to be the end-result of asset liability management or a fail-safe index of the financial soundness of the company concerned. Adequate tarification and technical provisions covered by sufficient assets remain the main pillars of solvency.

e. Reinsurance

Adequate and effective reinsurance enables insurance companies to share risks with others, and to maintain stable underwriting results by spreading risks. In emerging markets, many insurance companies are still struggling to increase their capital base in order to establish sound financial conditions. A reinsurer's strong capital base can assist the business development of such insurers. High quality reinsurers also provide direct insurers with essential technical knowledge on insurance and reinsurance. At the same time however, in emerging market economies, reinsurance is a new activity for insurance companies which often suffer unsuitable reinsurance contracts or transactions with financially unstable reinsurers. In some cases, insurance companies use reinsurance contracts only as a means of cash transfer abroad.

For this reason, reinsurance transactions, in emerging markets in particular, should be closely monitored. The supervisor must be able to review reinsurance arrangements to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them. A method for the collection and monitoring of information relating to reinsurance companies should be established. International cooperation is particularly important in obtaining accurate information and this should be developed.

At the same time regulatory intervention of reinsurance placement should not be abused. Only through liberal access to the wider international reinsurance market can both the ceding and accepting companies be assured of providing and obtaining the best product and service at a competitive price. Compulsory cession of risks to local reinsurers, domestic market or discriminatory tax regimes against foreign reinsurance placement should therefore be avoided.

f. Control of product and tariff

Rates of insurance products should be adequate, not excessive and not discriminatory. In emerging market economies however, the lack of experience in insurance management, combined with the shortage of basic statistical data such as the frequency and severity of losses, make it difficult to set appropriate rates based on actual risk exposure. A considerable number of policyholders have suffered due to bankruptcies of insurance companies which were often caused by under-pricing. Information asymmetry between insurers and consumers is even greater in emerging markets due to insufficient disclosure of information on products and companies. It is difficult for prudent companies to compete against others that charge prices lower than cost in order to gain market share. Thus, initially at least, it may be appropriate for emerging market economies to request submission of premium rates to insurance supervisory authorities for prior approval.

Similarly, it may be preferable that the insurance products offered for sale be examined by the supervisory authority so that those seeking insurance will not be harmed by inappropriate policy conditions.

Supervision of tariffs and products should however be adapted to the particular situation of each country and reassessed at a later stage according to the development and progress of the market.

g. Intermediaries

Intermediary systems play a key role in consumers benefiting from a market oriented economy and thus choosing the best suitable products from a wide product range. The importance of properly controlled insurance intermediaries may be particularly relevant in emerging market economies where abuses in the distribution network are often observed that cause considerable problems for policyholders. Normally, insurance legislation distinguishes between brokers who represent the buyer and generally work with several companies to provide the best coverage for their clients, from agents or direct sales who represent the seller(s). Regulations on intermediaries should clearly state the scope of business and rights and responsibilities of intermediaries.

Supervision of intermediaries could take a variety of alternative or complementary forms. It can be carried out under the insurance supervisory authorities or through an independent body or industry organisation.

Insurance intermediaries should be registered or be required to obtain authorisation prior to commencing their operations. Insurance intermediaries should possess professional qualifications that prove general, commercial and professional knowledge and ability to ensure that consumers are protected. Insurance brokers are liable to their clients and thus should possess either financial guarantees or professional liability insurance or both, for the purpose of policyholder protection and of maintaining a sound intermediary system. Insurance intermediaries should disclose to their clients their status and provide extensive information on and comprehensive explanations of insurance products to policyholders.

h. Compulsory insurance

Compulsory insurance may be justified in respect of certain forms of social protection and might be considered in other areas where the risks covered are particularly serious and are not covered on a non- compulsory basis. Premium payments should be divided on an equitable basis among the policyholder group under consideration. Compulsory insurance is particularly recommended for automobile third party liability. Some emerging market economies do not have functioning compulsory third party automobile insurance, even though automobile accidents are frequent and victims are often not sufficiently compensated.

In order to establish a properly functioning compulsory insurance system, a suitable monitoring system is crucial for ensuring that all relevant parties have insurance contract. For this purpose, a penalty system for those who breach obligations could be set up. A guarantee funds system could be created to compensate victims in cases where there is no insurance cover. Tariffs for compulsory

insurance should also be based on statistical data. Underwriting compulsory insurance should not be limited to particular companies such as (former) state monopolies.

5.4.3 Remedial correction of problems

a. Remedial procedures

Even in well-controlled insurance markets, it may happen that a company confronts financial difficulties that lead to insolvency. For this reason, there should be well formulated policies for achieving corrective action and in cases where an institution is not viable as a going concern, orderly exit policies are essential to effectively exercise insurance supervision. Of particular importance in this context are remedial (going from preventive recovery measures up to sanctions) to deal with the financial problems of individual insurance companies. Clear instructions on this matter should be defined in legislation, covering matters connected with the management of troubled companies including: the standards applied in monitoring insolvency, the basis for being able to do a reorganisation by restoring solvency, available recovery measures, the revocation of licences, conditions under which the portfolio of insurance policies may be transferred to a sound company, the role of the liquidator and the ranking of creditors' claims. Because long delay can magnify the cost of resolving a crisis, it is of great benefit to have available concrete procedures for prompt corrective actions. Permanent supervision focused on preventive control through on-site and off-site inspection will play a key role for this purpose. Corrective procedures based on rules can help to reduce political pressures for undue forbearance.

At the same time however, authorities need to retain sufficient discretion to be able to deal flexibly with problems that arise and be able to adapt the means for dealing with problem insurance companies to market circumstances.

b. Design and application of safety net arrangements

Protection of policyholders and the high cost of a possible collapse of the insurance system are principal reasons why in certain countries, the supervisor provides a safety net (guarantee funds). Under certain conditions and particularly if the domestic market comprises a sufficient number of potential contributors with a broad spread of risks, creation of a safety net could be considered. However, such an arrangement inevitably creates moral hazards because it holds the prospect that stakeholders will be at least partially indemnified from losses caused by failing institutions. In order to minimise the moral hazard, it is essential to design and apply safety net arrangements in which the incentives of stakeholders to exercise oversight and to act prudently are not undermined.

6. Developing essential measures for insurance markets in emerging economies

The IAIS, in particular, the Emerging Market Issues Committee and the Education Committee will play a key role in promoting and fostering the principles and measures mentioned above.

6.1 Developing guidance on regulation and supervision of emerging market economies

Currently there is no comprehensive practical and concrete text which describes measures on legislation and supervision in detail for assisting in fostering a sound insurance system in emerging market economies, although it is indispensable during the process of introducing a new insurance system or of amending the current regulations or insurance supervisory system.

Thus the Emerging Market Issues Committee of the IAIS will develop a practical and concrete text for insurance legislation and supervision in order to help those economies to implement the principles and best practice established (or going to be established) by the Technical Committee. Such an exercise will provide other aspects on insurance supervision and would eventually contribute to the activities of the Technical Committee.

This exercise will take the following steps:

- collect relevant materials from member countries and international organisations such as the Basle Committee, IOSCO, OECD and UNCTAD on the practical measures for implementing sound supervision. Close cooperation with the Laws and Regulations Committee will be useful;
- determine priorities on supervisory issues for emerging market economies;
- draft concrete analysis on the issues which require priority; and
- guidance will be drafted by a small task force made up of members of the Emerging Market Issues Committee and Educational Committee and the prepared draft will be discussed in both Committees.

6.2 Implementing sound principles and standards in emerging market economies

6.2.1 Training and seminars

The effectiveness of a supervisory body depends mainly on the human resources at its disposal. Taking into account the shortage of qualified staff and proper resource development strategies, well organised training schemes for supervisors are crucial to the emerging market economies. Training for supervisors should consist of both theoretical and practical aspects and of both legislative and supervisory aspects. It should not be a single event but should be conducted continuously and be based on well arranged programmes. However, at the moment, training courses, materials and methods for supervisory staff are not arranged systematically in many cases.

Within this process, an active role of the recipient countries should be particularly encouraged so as to ensure that training addresses their needs.

The training programmes for insurance supervisors in emerging market economies drafted by Mr. Bellando, the Chairman of the Education Committee of the IAIS are to:

- organise supervisory training by geographical area (Africa, Central and South America, Asia, East European countries);
- organise a total of four training programmes in two years, i.e. one for each geographical area;
- the themes of the training programmes will be determined on the basis of both the results of the survey made by the Emerging Markets Committee and the main sections of the Manual (licensing, control and supervision, investments, solvency);
- each organiser will contact the countries in his/her zone and the competent regional organisations. He/she will settle the plan, duration, language and location of the training. He/she will report back to the Education Committee;
- funding will be determined by the Education Committee in consultation with the Emerging Market Issues Committee; and
- some training could be organised in cooperation with the national or international organisations.

As suggested by Mr Molgaard (Denmark), the Committee should also consider organising missions to emerging market economies in order to:

- carry out the terms of reference of the Emerging Market Issues Committee and contribute to raising the level of both the insurance industry and the insurance market
- recruit more IAIS members;
- create a prototype for insurance industry supervision;
- develop know-how on technical assistance on the same lines as the extensive technical and financial support for the banking system; and
- establish a base for channelling technical assistance and financing from the industrial countries to the emerging market economies.

6.2.2 Coordination

The IAIS will also play a key role in co-ordinating technical assistance on insurance issues in emerging markets. Due to its large membership (in both industrial and emerging market economies) and its unique international role on insurance supervision, the IAIS is in an ideal position to be a central intermediary between organisations which provide technical assistance and users of technical assistance. Furthermore, the IAIS will also play a co-ordinating role in ensuring that technical assistance provided by various institutions is complementary. At present, the EU, OECD, UNCTAD and the World Bank as well as other international organisations, certain governments, academic

societies and private sector bodies, etc., all organise their own technical assistance programmes, training, seminars with limited co-ordination between them.

Therefore, the Emerging Market Issues Committee and the Education Committee will:

- further develop the results of the research prepared by Mr. Butterworth former Chairman of the Education Committee, concerning training requests and organisations which provided training;

- prepare and send a questionnaire on those providing technical assistance and requests for technical assistance to all IAIS member countries, non-IAIS member countries and international organisations under the initiative of Mr. Bellando, Chairman of the Education Committee; a questionnaire will cover questions on concrete assistance programmes, the possibility of financial assistance, name and address of the contact persons (organisations which provide training) and on results of using technical assistance including training courses, future needs for training and other technical assistance and suggested topics, etc., (training requirements);

- analyse the collected answers and assess the needs for assistance and possible organisations which provide assistance;

- nominate a person from the Education Committee to strengthen co-ordination between organisations which provide assistance and requests for assistance, between the IAIS and other organisations which provide technical assistance on insurance supervision. He/she will take the initiative in exchanging information and co-ordinating seminars or training programmes. He/she will foster bilateral exchange visits and studies for supervisors; and

- nominate a key person from each region to co-ordinate technical assistance programmes in that region.

6.3 Further development of guidance for insurance regulation for emerging market economies and their training programmes

The activities of the Emerging Market Issues Committee and the Education Committee is not static, but evolve and develop through experience. The experience and information obtained by seminars, training and missions will be utilised to further develop a practical text and measures for supervisors. The interaction between the text and training will be mutually beneficial, leading to the higher level of expertise in both fields.

Guidance Paper No.2

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

A MODEL MEMORANDUM OF UNDERSTANDING

September 1997

Memorandum of Understanding on Mutual Assistance and the Exchange of Information between the Authority/Jurisdiction and the Authority/Jurisdiction

Attached is a draft Memorandum of Understanding (MoU) on mutual assistance and the exchange of information.

MoU are designed to facilitate co-operation and the exchange of information between regulatory bodies. As such they are statements of intent which do not impose legally binding obligations on signatories or override domestic laws or regulations. Nor do they affect other channels of co-operation, such as arrangements which may exist covering mutual assistance in criminal matters. The strengths of MoU are seen to be in their ability to accommodate the differences between regulators, and in the flexibility they provide in responding to changing legal and regulatory environments.

Whilst the draft MoU may for some be a serviceable model on which to negotiate, there is no suggestion that IAIS members should be able to implement all the provisions in the draft. It is for individual members - in the light of their own laws, regulations and requirements - to decide whether they wish to use the text in its entirety or in part in seeking to agree a MoU with another jurisdiction. Alternatively IAIS members may simply wish to use the draft as an aide memoire as to some of the elements that an optimal MoU might include, and develop their own text reflecting the particular circumstances within their jurisdiction.

One of the key aspects of a successful MoU is the opportunity it provides to develop the relationship between the Authorities concerned. With this in mind, supervisors are encouraged to have regular contacts or meetings with each other to exchange information on developments affecting individual insurers or other general insurance developments.

September 1997

1. The [*Authority/jurisdiction*] on the one hand, and the [*Authority/jurisdiction*] on the other hand, recognising the increasing international activity in insurance markets and the corresponding need for mutual co-operation between the relevant supervisory authorities as a means for improving their effectiveness in administering and enforcing the insurance laws of their respective jurisdictions, have reached the following understanding:

NOTES:

a. The terms of this draft MoU are limited to the exchange of information and mutual co-operation in insurance markets. Those negotiating MoU may wish to extend the scope to include superannuation business if they have a role in this area.

b. A possible alternative introduction would set out in two or more paragraphs the responsibilities of the Authorities of the two jurisdictions and the relevant legislation before going on to include text along the lines of that above.

Definitions

2. For the purposes of this Memorandum of Understanding, the terms set out below have the assigned meanings unless the context requires otherwise:

a. "Authority" means:

(i) for the [*jurisdiction*], the [*Authority*];
(ii) for the [*jurisdiction*], the [*Authority*].

b. "requested Authority" means an Authority to whom a request under this Memorandum is addressed.

c. "requesting Authority" means an Authority making a request under this Memorandum.

d. "Insurer/insurance company" means a licensed legal entity which underwrites insurance.

e. "person" means a natural person, unincorporated association, partnership or body corporate, government, agency, or instrumentality of a government.

f. "laws, regulations and requirements" means the provisions of the laws, or the regulations and requirements promulgated thereunder, of [*jurisdiction*] and [*jurisdiction*] on insurance business.

3. The parties recognise that while in their laws, regulations and requirements they may define terms differently, requests for assistance will not be denied solely on the grounds of differences in the definitions used by the requesting and requested Authorities.

NOTES:

c. Including too many definitions may make the MoU unduly legalistic, and could potentially restrict the scope for co-operation if the definitions were to be narrowly interpreted by those charged with implementing the MoU in the future. However, it is probably necessary for a clear common understanding of the provisions of the MoU to define some of the terms utilised within it. It is up to those negotiating MoU to decide how far they wish to go in this respect.

d. No attempt has been made here to define insurance business to be covered by the MoU - because of the differences which exist between jurisdictions - but those negotiating MoU may wish to consider doing so. In particular it should be clear whether or not the MoU is intended to cover reinsurers/reinsurance business. It may be appropriate to list the relevant laws, regulations and requirements of each jurisdiction in an Annex to the MoU.

Principles

4. This Memorandum sets forth the basis upon which the Authorities in [*jurisdiction*] and [*jurisdiction*] [reciprocally] propose to provide for mutual assistance and the exchange of information for the purpose of facilitating the performance of their functions under the respective laws, regulations and requirements of [*jurisdiction*] and [*jurisdiction*]. The purpose of the Memorandum is to [ALTERNATIVE A: help maintain efficient, fair, safe and stable insurance markets in [*jurisdiction*] and [*jurisdiction*] for the benefit and protection of policyholders] [ALTERNATIVE B: protect policyholders and potential policyholders of insurance companies, and to promote the integrity, stability and efficiency of the insurance industry], by providing a framework for co-operation, increased mutual understanding, the exchange of information and assistance to the extent permitted by laws, regulations and requirements.

NOTES:

e. Alternative A above reflects wording in the IAIS By-laws. Alternative B is adapted from similar provisions in securities MoU.

5. The Authorities intend to:

- use their best endeavours to ensure that the fullest mutual assistance is provided within the terms of the Memorandum; and
- engage in consultations, as appropriate, on mutually agreeable approaches designed to enhance the integrity and efficiency of their respective insurance markets and the exercise of insurance market supervisory functions.

6. The Authorities have various powers to obtain information in the exercise of regulatory functions that are within the scope of this Memorandum. To the extent permitted by laws, regulations and requirements, each Authority will [use reasonable efforts][endeavour] on a timely basis to provide the other Authority with any information that is in its possession or discovered which appears to give rise to a breach of the laws, regulations or requirements of the other Authority, or if provided to the other Authority will be likely to assist in administering the laws, regulations or requirements of the other Authority.

7. The Memorandum does not modify or supersede any laws, regulations and requirements in force in, or applying to, the [*jurisdiction*] or [*jurisdiction*]. Nor does it create directly or indirectly any enforceable rights.

Scope

8. Each Authority proposes to ensure that mutual assistance is provided to the other, subject to its laws and overall policy, in the following areas of administration and enforcement of the laws, regulations and requirements relating to the business of insurance:

a. administration of legislative provisions dealing with proposals for the establishment, acquisition and take-over of insurance companies;
b. administration and enforcement of financial and other eligibility requirements for key positions of responsibility in insurance companies including ownership;
c. the continuing monitoring, auditing, inspection and examination of insurance companies for compliance with prudential, financial reporting and other supervisory requirements;
d. the conduct of specific inquiries into the activities of individual insurance companies;
e. ensuring compliance with disclosure and marketing requirements for insurance products; and
f. fraudulent practices in relation to the offer, purchase or sale of insurance products.

The Authorities will take into account the standards developed by the International Association of Insurance Supervisors where these are relevant.

NOTES:

f. It is clearly for those negotiating MoU to determine on the basis of their respective responsibilities whether they wish to extend the provisions to cover - for example - insurance intermediaries and/or the sale and marketing of insurance, in addition to the regulation of the financial strength of insurance companies and the fitness of individuals engaged in the insurance industry.

g. Article 8(b) may need to take account of any restrictions which may be imposed locally by privacy legislation.

9. In response to requests that satisfy the terms set out below under the heading "Requests for information and assistance", and subject to the conditions established, each Authority will provide the fullest possible measure of mutual assistance to the other subject to its laws and overall policy. Such assistance may include:

a. providing access to information in the files of the requested Authority;
b. questioning or taking testimony of persons designated by the requesting Authority;
c. obtaining specified information and documents from persons;
d. conducting compliance inspections or examinations of insurance businesses; and
e. permitting the representatives of the requesting Authority to participate in the conduct of enquiries made by the requested Authority pursuant to b through d of this paragraph.

Each request will be assessed on a case by case basis by the requested Authority to determine whether assistance can be provided under the terms of the Memorandum.

10. The Authorities recognise the need and desirability of providing mutual assistance and exchanging information to assist each other in securing compliance with their respective laws, regulations and requirements. However, assistance may be denied on the grounds of public interest.

NOTES:

h. Public interest is taken to include issues affecting sovereignty, national security, and other essential interests.

11. The Authorities intend to ensure that assistance will be provided in the maximum number of circumstances. However, the Authorities acknowledge that certain requests may relate to a possible breach of laws, regulations and requirements that involve an assertion of jurisdiction not recognised by a requested Authority. Where a requested Authority considers that an assertion of jurisdiction in a matter that is the subject of a request would conflict seriously with and prejudice its sovereign interests the request will be denied.

12. The Authorities recognise that, so long as there are differences in the scope of the laws, regulations and requirements applied in each jurisdiction, conduct prohibited by the Authorities in one country may not be prohibited by the Authorities in the other. The Authorities intend to engage in consultations about individual cases falling outside the scope of the definition of laws, regulations and requirements to determine whether assistance will be provided in such cases.

Requests for information and assistance

13. The Memorandum does not affect the ability of the Authorities to obtain information from persons on a voluntary basis, provided that procedures in place in the jurisdiction of each Authority for the provision of such information are observed.

14. Any request for information or assistance made under this Memorandum will, wherever possible, be in writing, but in cases of urgency it may be oral and confirmed in writing within ten days.

15. To facilitate an appropriate and timely response, the requesting Authority should specify:

a. the information or assistance required (identity of persons, specific questions to be asked etc);
b. the purpose for which the information or assistance is sought (including in appropriate cases details of the law, regulation or requirement of the requesting Authority which is suspected to have been breached);
c. a description of any particular conduct or suspected conduct which has given rise to the request, and its connection with the jurisdiction of the requesting Authority;
d. the link between any suspected breach of law, regulation or requirement and the regulatory functions of the requesting Authority;

e. the relevance of the requested information or assistance to any suspected breach of law, regulation or requirement of the requesting Authority;
f. whether it is desired that, to the extent permitted by the laws applying to the requested Authority, any persons from the jurisdiction of the requesting Authority should be present during interviews which form part of an investigation, or the conduct of an inspection, and whether it is desired that such persons should be permitted to undertake an active role - for example by participating in questioning or the taking of testimony;
g. any other matters specified by the laws and regulations in the jurisdiction of the requested Authority; and
h. any information related to the urgency of the request for information or assistance.

The requested information must be reasonably relevant to securing compliance with the law, regulation or requirement specified in the request.

16. A request for information or assistance made under this Memorandum shall be addressed to one of the requested Authority's contact points listed in Annex 1, or that individual's nominee.

17. Each request will be assessed on a case by case basis by the requested Authority to determine whether assistance can be provided under the terms of the Memorandum. In any case where the request cannot be accepted completely, the requested Authority will consider whether there may be other assistance which can be given. In particular, the requested Authority will consider in appropriate cases whether the request might be dealt with via channels for mutual assistance in criminal matters.

18. In any case where a requested Authority is not satisfied that a request fully complies with the requirements of the Memorandum, it may require the [Director][Head] of the requesting Authority to certify that the request meets the provisions in this Memorandum. The requested Authority should review its position in the light of such a certification.

19. In deciding whether to accept or decline a request the requested Authority will, in particular, take account of:

a. matters specified by the laws and regulations in the country of the requested Authority;
b. whether the request involves an assertion of jurisdiction not recognised by the country of the requested Authority;
c. whether it would be contrary to the public interest of the requested Authority to give the assistance sought; and
d. the resources available to the requested Authority to deal with the request.

20. The requested Authority may, as a condition of agreeing that assistance is given under the Memorandum, require the requesting Authority to make a contribution to costs. Such a contribution may, in particular, be required where the cost of a request is substantial or where a substantial imbalance has arisen in the cumulative costs incurred.

Procedures for questioning or taking testimony and conducting inspections

21. In accordance with paragraph 9 above:

a. questioning or taking the testimony of persons, if requested, will be conducted in the same manner and to the same extent as investigations or other proceedings under the laws of the jurisdiction of the requested Authority;
b. when requested by the requesting Authority, questioning or taking testimony will be conducted under oath and a transcript made;
c. a representative of the requesting Authority may be present at the questioning or testimony, may prescribe specific questions to be asked of any witness and, pursuant to paragraph 22 of this Memorandum, may otherwise participate in the examination of any witness.

NOTES:

i. It is recognised that only some Authorities will have the ability to take testimony under oath.

22. Subject to the following conditions, a requested Authority may grant a request made by the requesting Authority that a person or persons designated by the requesting Authority, including representatives of the requesting Authority, be permitted to conduct the interrogation of any person, or participate in the inspection or examination of the books and records of an insurance business or its custodian or agent:

a. the requesting Authority must specify the reasons for this request;
b. it is for the requested Authority to decide whether to grant or deny the request, within the framework provided by this Memorandum. The requested Authority may impose such conditions on the participation of the requesting Authority as it deems appropriate;
c. if the request is granted and the laws of the jurisdiction of the requesting Authority require the opportunity for the witness to consult with legal counsel, or for counsel to the witness to pose questions to the witness, such participation will, subject to (b) above, be permitted; and
d. if the request is denied, the Authorities agree to consult pursuant to paragraph 30 of this Memorandum concerning the reasons for the denial and the circumstances under which the request might be granted.

23. Notwithstanding any other provision of this Memorandum, any person providing testimony, information or documents as a result of a request made under this Memorandum will be entitled to all the rights and protections of the laws of the jurisdiction of the requested Authority. Where assertions are made regarding other rights and privileges arising exclusively pursuant to the laws of the jurisdiction of the requesting Authority, the Authorities will consult to determine the most appropriate way to proceed.

Permissible uses and confidentiality

24. The information supplied will be used solely for the purpose of:

a. securing compliance with or enforcement of the law, regulation or requirement specified in the request by initiating or assisting in criminal prosecution arising out of the breach of such law;
b. conducting or assisting in civil proceedings arising out of the breach of the law, regulation or requirement specified in the request and brought by the Authorities or other law enforcement or regulatory bodies within the jurisdictions of [*jurisdiction*] or [*jurisdiction*]; and
c. taking regulatory action or imposing regulatory requirements within the areas set out in paragraph 8 above.

25. Each authority will keep confidential [to the extent permitted by law]:

a. any request for information made under the Memorandum and any matters arising in the course of its operation, unless such disclosure is necessary to carry out the request, or the requested Authority specifically waives such confidentiality;
b. any information passed under the Memorandum unless it is disclosed in furtherance of the purpose for which it was requested.

26. Unless the request provides otherwise, the confidentiality provisions of the Memorandum shall not prevent the Authorities from informing other law enforcement or regulatory bodies within the jurisdictions of [*jurisdiction*] and [*jurisdiction*] of the request or of passing information received pursuant to a request to such bodies, provided that:

a. such agencies or bodies have responsibility for prosecuting, regulating or enforcing laws, regulations and requirements falling within the areas set out in paragraph 8 above;
b. the purpose of passing such information to such an agency or body falls within the areas set out in paragraph 8; and
c. the requesting Authority has provided any such undertaking in relation to the information requested which is required by [the law of the jurisdiction of] the requested Authority.

27. The requesting Authority will notify the requested Authority of any legally enforceable demand for information it receives, and will assert such [appropriate][relevant] legal exemptions or privileges with respect to such information as may be available. The requesting Authority will consult with the requested Authority prior to complying with any such demand.

28. Any document or other material provided by an Authority in response to a request under this Memorandum and any copies or other material disclosing its contents, other than material generated as part of the deliberative, investigative, internal or analytical process of the requesting Authority, will not become the property of the requesting Authority.

29. In response to a request by the requested Authority, and to the extent permitted by the laws of the jurisdiction of the requesting Authority, as soon as the requesting Authority has completed action on the matter for which assistance has been requested under this Memorandum, it will return to the requested Authority all documents and copies thereof not already disclosed in proceedings referred to in paragraph 24 above, and other material disclosing the content of such documents, other than material generated as part of the deliberative, investigative, internal or analytical process of the requesting Authority, which may be retained.

Consultations and waiver

30. The Authorities will keep the operation of this Memorandum under continuous review and consult with a view to improving its operation and resolving any matters. In particular, an Authority will consult the other Authority upon request in the event of:

a. a request being denied in whole or in part;
b. a change in market or business conditions or in the laws, regulations or requirements governing insurance business, or any other difficulty arising which makes it necessary to amend or extend this Memorandum in order to achieve its purposes; or
c. an assertion by the requested Authority that the provision of assistance would be so burdensome as to disrupt the proper performance of its functions.

31. Where the specific conduct set out in the request for assistance may constitute a breach of a law, regulation or requirement in both the territory of the requesting and the requested Authorities, the relevant Authorities will consult in order to determine the most appropriate means for each Authority to provide assistance.

32. Any of the conditions of this Memorandum may be relaxed or waived by mutual agreement.

Termination

33. This Memorandum will continue to have effect unless terminated by one of the Authorities by giving thirty days advance written notice to the other Authority that the understandings set out herein are no longer to have effect.

Contact points

34. All communications between the Authorities should be between the principal points of contact listed in Annex 1 unless otherwise agreed.

Entry into effect

35. This Memorandum will be effective from the date of its signature by the [*Authority/jurisdiction*] and [*Authority/jurisdiction*].

Signed this [ ] day of [ ] 199[]

Contact points

Guidance Paper No. 3

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE PAPER FOR FIT AND PROPER PRINCIPLES AND THEIR APPLICATION

October 2000

Guidance Paper for Fit and Proper Principles and their Application

Contents

1. Introduction

1. The fit and proper principles are sensitive issues in many jurisdictions and their application may vary according to the legal and political climate of the jurisdiction. For these reasons this paper is for guidance only.

2. Background

2. The Joint Forum has prepared a paper on "fit and proper principles" as it applies to conglomerates, which was endorsed by IAIS in San Francisco in December 1999.

3. However, the paper does not address the issue of fit and proper principles in relation to single entities, nor in relation to groups of companies within a single discipline, e.g. insurance. Accordingly, this paper extends the scope of the Joint Forum paper and contains a section on the application of those fit and proper principles in relation to insurance entities.

4. For the purposes of this paper, 'insurance entities' can be defined as any corporate body or individual which is operating as an insurer, reinsurer or insurance intermediary and which is subject to insurance regulation.

5. The fit and proper principles contained in the Joint Forum paper on conglomerates can be extended easily to insurance entities. Insurance entities may be simpler to assess because the competency requirements cover only a single industry.

3. Objective

6. The objective of this paper is identical to that in the Joint Forum paper. It is repeated below, amended to refer to the regulation of insurance entities.

7. To ensure that supervisors of insurance entities are able to exercise their responsibilities to assess whether insurance entities are soundly and prudently managed and directed and that key functionaries (directors, managers, shareholders and others who exercise a material or controlling influence over the affairs of the insurance entity) do not pose a risk to the interests of present and future policyholders and beneficiaries of these entities.

8. On a case-by-case basis and when requested by other insurance supervisors, to promote arrangements to facilitate consultation between supervisors and the exchange of information on individuals and regulated insurance entities, to achieve the above.

4. Fit and Proper Principles

9. The Joint Forum paper lists seven principles, which are noted below, adapted in relation to insurance entities. Principles 5, 6 and 7 of the Joint Forum paper, have been combined below as one principle.

4.1 Necessity

10. In order to assist in ensuring that supervised insurance entities are operated prudently and soundly, fitness and propriety or other qualification tests should be applied.

4.2 Subjects

11. These tests should be applied to key functionaries (directors, managers, shareholders and any other persons exercising a material or controlling influence on the management, operations or shareholding of supervised insurance entities – sometimes termed "controllers"). Certain jurisdictions may require that these tests also be applied to other senior employees (for example, underwriters, financial controllers, treasurers, etc).

4.3 Timing

12. Fitness, propriety or other qualifications tests should be applied at the authorisation stage and thereafter, on the occurrence of specified events.

4.4 Responsibility

13. Supervisors' expectations are that insurance entities will take the measures necessary to ensure that fitness, propriety or other qualification tests are met on a continuous basis.

4.5 Supervisory Cooperation

14. In cases where key functionaries are known to have connections in other jurisdictions, supervisors should communicate with those supervisors in the relevant jurisdictions as part of the assessment procedure.

a. Supervisors should contact the insurance supervisors in the jurisdictions concerned. However, if an individual (or corporation) has been working outside the insurance sector but in a regulated financial services sector in another jurisdiction, it may also be necessary to exchange information with the supervisor in that other sector;

b. Where there is no direct channel to a supervisor in another jurisdiction, it may be possible to route information to the relevant domestic supervisor (of the key functionaries) for onward transmission;

c. Supervisors' "reach" may not extend to other entities in the group which are regulated by supervisors in other jurisdictions, or to unregulated entities in the parent group. In such cases, supervisors should be aware that measures taken to apply fitness, propriety or other qualification tests to such entities may create the false impression that supervision generally extends to those other (or unregulated) entities.

d. Most countries have legislation in place protecting the privacy of individuals and accordingly it is recognised that there may be limitations to a free exchange of information between supervisors.

e. It may be that arrangements to exchange information between supervisors should be formalised in agreements, e.g., Memoranda of Understanding, to establish a framework for the efficient transfer of such information.

5. General Statements

15. The Joint Forum paper contains a large number of statements of suggested practice. For the purposes of this paper, certain of these have been incorporated below (amended and summarised), to outline the general approach to which insurance supervisors should have regard. However, for completeness of statement and intent, reference should always be made to the Joint Forum paper.

a. Insurance supervisors may be subject to statutory and other requirements in applying fitness, propriety or other qualification tests to the insurance entities under their jurisdiction. It is not

intended that such statutory and other requirements (as well as procedures for the application of those tests) should be superseded by the principles and applications set out in this paper.

b. An effective and comprehensive supervisory regime should include controls designed to encourage the continued satisfaction of the fitness, propriety or other qualification tests of supervisors and to allow supervisory intervention where necessary.

c. Supervisors should have at their disposal various sanctions to ensure remedial measures are taken in respect of key functionaries who do not meet the relevant fitness and propriety or other qualification standards. An appropriate appeals process should be made available to individuals affected by remedial determinations made against them.

d. When acquiring responsibilities and powers in new areas of the provision of financial services, (e.g. in circumstances of new or changed legislation), the supervisor may take into consideration evidence of past performance of insurance entities and their key personnel.

e. Supervisors should be aware that, as concerns the functions and responsibilities of directors and officers, there are significant differences in legislative and regulatory frameworks from country to country. In some countries, there is a two tier board system consisting of a supervisory board which has a main function of supervising the management board. Thus, the supervisory board has no executive functions. In other countries, with a unitary board system, the board has a broader responsibility. In this regard, fitness, propriety or other qualification tests should be applied to directors in the light of their role and responsibilities.

f. It is recognised that in addition to the factors identified in the previous paragraphs, the assessment of fitness, propriety and other qualifications may be a judgmental matter and that supervisors may have additional information at their disposal that they can consider on a case-by-case basis.

g. It is recognised that an individual considered fit for a particular position within an institution may not be considered fit for another position with different responsibilities or for a similar position within another institution, and conversely, an individual considered unfit for a particular position in a particular institution may be considered fit in different circumstances.

6. Application of the Fit and Proper Principles

6.1 Individuals

16. In determining whether individuals are fit and proper to hold the position of shareholder, director, officer or manager, in an insurance entity a supervisor shall consider:

a. whether the individuals have sufficient skills, knowledge and soundness of judgement to undertake and fulfil the particular duties and responsibilities;

b. the relevant competence, diligence and soundness of judgement of the individuals, including previous experience, track record, qualifications and training;

c. the individuals reputation and character;

d. in respect of soundness of judgement, the degree of balance, rationality and maturity demonstrated in conduct and decision-taking, including whether they have engaged in, or been associated with, any unsatisfactory business practices;

e. generally, whether the interests of policy owners, insurance claimants, customers and creditors of the insurance entity are in any way threatened by the individuals occupying the position.

17. In addition, the individuals should not have a record or evidence of previous business conduct and activities where individuals have:

a. been convicted for an offence under any legislation designed to protect members of the public from financial loss due to dishonesty, incompetence or malpractice;

b. engaged in any business practices appearing to be deceitful or oppressive or otherwise improper, whether unlawful or not, or which otherwise reflect discredit on the individuals methods of conducting business;

c. been a party to any action or decision of the board or management of the insurance entity, which was detrimental to the interests of the entity, and if appropriate, its policy holders.

18. The individuals should also have achieved a satisfactory outcome as a result of security and financial vetting:

a. Security vetting may be undertaken with the help of law enforcement agencies (usually a government or police anti-fraud authority), who will carry out their own investigations with the relevant authorities, to establish if there is any criminal record involving fraud, criminal breach of trust, forgery and other criminal offences, eg relating to dishonesty. Information required of an Individual applicant, for the purposes of security and financial vetting, is provided in Annex 1;

b. The supervisor in the country of origin of the business operation should be contacted to ascertain whether there are records of non-compliance, contravention of the statutory acts and regulation, non-cooperation, industry misconduct, etc.

c. Financial vetting with the financial supervisory authorities may be undertaken. Such information will demonstrate whether there is any financial misconduct, improper conduct of financial accounting with financial institutions, bad loans, record of corruption activities or whether the applicant has been judged to be a bankrupt.

d. The supervisor may require that insurance entities have in place policies for self-assessment and may have reserve powers to remove unfit or improper individuals.

19. If necessary, an interview could be conducted with the prospective applicant.

20. Once an insurance entity is authorised, the supervisor should continue to take account of performance of all relevant individuals:

a. imprudence in the conduct of business, or actions which have threatened the interests of policy holders will reflect adversely on the competence and soundness of judgement of those responsible;

b. failure by an insurance entity to conduct its business with integrity and professional skills will reflect adversely on the probity, competence, and soundness of judgement of those responsible. This applies whether the matters of concern have arisen from the way the individuals responsible have acted or from their failure to act in an appropriate manner;

c. assessment of the significance of such actions or omissions should be a cumulative approach; that is, the supervisor may judge that an individual does not fulfil the criterion on the basis of several instances of such conduct which, if taken separately, might not have led to such a conclusion.

6.2 Corporate Institutions

21. Corporate institutions are sometimes shareholders and or directors and officers (i.e. key functionaries) in insurance entities. In these cases the test and evaluation of fit and proper principles should also be applied to these institutions.

22. In the broad test of fitness and probity for institutions, insurance supervisors should look for evidence that the institutions meet a high standard by reviewing the following:

a. their financial soundness and strengths;

b. the nature and scope of their business;

c. the key functionaries;

d. the group structure (if applicable) and organisation chart.

23. Where necessary and where the corporate institutions are regulated entities in another jurisdiction the insurance supervisor should seek confirmation from the relevant regulators that the institutions are in good standing in that other jurisdiction.

Annex I

Information Required for the Purpose of Security and Financial Vetting of an Individual

This annex contains a selection of information that an insurance supervisor may ask for to be submitted for assessment purposes. The annex is meant for guidance only and it is for the supervisor concerned to select the appropriate questions. Local data protection laws of certain countries may not permit some of the following information to be requested, retained or disclosed. In such situations, the supervisor should seek to obtain as much relevant information as is legally permitted, to enable a judgement to be formed on the suitability of the individual for that position.

- Name (and any previous names):
- Private and business address (including any other private addresses within the last 15 years), current telephone, fax and e-mail addresses:
- Date and place of birth:
- Nationality (and any previous nationality):
- Passport/identity card:
  - Number:
  - Date and place of issue:
  - Issuing authority:
- Name and address of bank:
  - Account numbers and type of account:
  - Details of any loans or guarantees issued to or on behalf of the company in which the applicant has a management or shareholding interest.
- Family status:
- Details and dates of academic qualification:
- Details and dates of professional qualification:
- Description of the prospective position (including responsibilities) and proposed date of commencement:
- Working experience:
  - Existing and previous employers (covering the last 15 years):

- Details of whether the applicant and / or his employers have been formally supervised or regulated
- Nature of employer's business
- Designation:
  (including duties and responsibilities)
- Date of appointment:
- Date of resignation / departure:
- Reason for resignation / departure.
- Details of other business interests in the last 15 years where the applicant has been a working shareholder, director or controller.

- Relationship with the company and other third parties:-
  - Details of shareholdings or voting powers in the company, related or third parties:
  - Details of any business relationships with the company, related or third parties:
  - Details of any business relationship between the applicant's former employers and the company, related or third parties:

- Full details on the applicant's reputation and character:-
  - Whether the applicant has ever been declared bankrupt;
  - Any convictions of any offence involving fraud or other dishonesty;
  - Any disqualification of the applicant from acting as a director or in the management of any company or organisation;
  - Whether the applicant has ever been refused (or had revoked) a licence or authorisation to carry on any regulated financial business;

- Any censure or disciplinary action initiated by any governmental, regulatory or professional body;

- Any dismissals from office or employment, subjection to disciplinary proceedings by the applicant's employer or been refused entry to any profession or occupation;

- Any litigation with which the applicant has been involved over the last 5 years;

- Whether any governmental, regulatory or professional body has ever investigated any employer, company or organisation with which the applicant has been associated with as a director, officer, manager or shareholder;

- Whether any company or organisation with which the applicant was associated as a director, officer, manager, shareholder or controller has ever been wound up, gone into receivership or

ceased trading either whilst the applicant was associated with it or within one year after the applicant so ceased to be associated.

Guidance Paper No. 4

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE PAPER ON PUBLIC DISCLOSURE BY INSURERS

January 2002

Guidance Paper on Public Disclosure by Insurers

Contents

1. Introduction

1. Public disclosure of reliable and timely information facilitates the understanding by prospective and existing policyholders and other market participants of the financial position of insurers and the risks to which they are subject. This paper provides guidance for public disclosures by insurance companies. It recognizes that supervisors have a role in encouraging companies to make effective disclosure.

2. Supervisors are concerned with maintaining efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders. This paper recognizes that risk disclosure is critical to the operation of a sound market. When provided with appropriate information that allows them to assess an insurer's activities and the risks inherent in those activities, markets can act efficiently, rewarding those companies that manage risk effectively and penalizing those that do not. This is often referred to as market discipline. It serves as an adjunct to supervision.

3. When insurers become insolvent, policyholders may suffer. There have been cases where expected payments from insurers were reduced, even when policyholder protection schemes are in place. Public disclosure provides consumers with information for making judgments about insurers before entering into contracts.

4. Individual policyholders do not always have the ability or resources to assess insurers' financial stability and understand insurer disclosures. This paper recognizes that other market participants, such as shareholders, equity analysts, insurance agents and brokers, rating

agencies and the news media help individual policyholders monitor insurer activities; albeit, their role and involvement varies both by country and within country by type of insurance product.

5. Regular disclosure can facilitate the smooth functioning of the markets. For example, timely public disclosure can reduce the severity of market disturbances because market participants are informed on a more ongoing basis and therefore are not as likely to overreact to information about current conditions. If disclosure of negative information about an insurer is sudden, it could cause policyholders to surrender their contracts in panic. Such action could further worsen the financial position of the insurer.

6. Markets require a higher level of disclosure about insurance companies than that applied to other companies because of the inherent uncertainties in the industry. These inherent uncertainties are natural in the insurance industry because of the unusual and inverse nature of an insurance contract: a policyholder paying regular or single premiums in exchange for an uncertain benefit of a sometimes uncertain amount at a sometimes uncertain point of time in the future. Because of these inherent uncertainties, there is

- a higher degree of estimation particularly as regards liabilities, than for other general business industries;
- the possibility of systemic underestimation (or overestimation) of liabilities (e.g. asbestosis experience); and
- a significant time lag between estimation and crystallisation of liabilities.

7. Insurers have a long tradition of estimation based on actuarial techniques. The underlying assumptions should be disclosed so that others can understand how they arrive at these estimations.

8. Greater disclosure entails increased costs, which may be direct or indirect. For example, companies may experience a competitive disadvantage from increased disclosure of proprietary information. These costs must be weighed against the potential benefits of increased disclosure required by any standards.

9. The insurance industry is becoming increasingly international. However, comparability of financial information across countries is difficult to achieve since accounting policies, practices and procedures differ considerably. Even within a country, insurance accounting policies, practices and procedures may differ from those used by other enterprises. Therefore, it is necessary to disclose accounting policies so that the financial information can be properly understood and interpreted.

10. It is recognized that the development of the insurance market varies widely around the world. Some IAIS members' insurance industries are less developed than those of other members. The level of disclosure should reflect the developmental state of the industry and the overall balance of products and markets. More sophisticated markets with more complex products will generally require more disclosure. Further, while comprehensive disclosure is a goal, the speed of implementation may vary by country as members balance the need to allocate resources towards implementing prudential, supervisory reporting vs. enhancing public disclosure.

Scope of paper

11. This paper provides guidance for public disclosure by insurers to enable market participants to understand an insurer's current financial condition and future viability. This information helps market participants assess an insurer's prospective ability over both the short and long term:

- to meet claims, liabilities and other obligations as they fall due; and
- to provide a return on investment to its stakeholders, including any shareholders and participating (with-profits) policyholders.

12. This paper does not propose any obligations for supervisors to disclose information that may be in their possession. The purpose of this paper is to provide guidance for public disclosures by insurance companies. The supervisor has an important role in encouraging companies to make effective disclosure. Nonetheless, this paper also recognizes that the insurance supervisors in many jurisdictions do not control the disclosure requirements, and that the responsibility for ensuring such disclosure may not rest with the insurance supervisor.

13. A captive insurer is not subject to the same market forces as commercial insurance companies. This paper does not apply to captive insurers. Nonetheless, supervisors are free to decide whether or not to apply the guidance in this paper to captives.

2. Quality of disclosure

14. Insurers should publicly disclose information that is:

a. relevant to decisions taken by market participants;

b. timely so as to be available and up-to-date at the time those decisions are made;

c. accessible without undue expense or delay by the market participants;

d. comprehensive and meaningful so as to enable market participants to form a well-rounded view of the insurer;

e. reliable as a basis upon which to make decisions;

f. comparable between different insurers and other companies; and

g. consistent over time so as to enable relevant trends to be discerned.

a. Relevance

15. Information is relevant where it is material. Information is material if there is a substantial likelihood that a market participant would consider it important in making a key decision. Typically, the key decisions are whether to insure risks with, invest in or effect other transactions with an insurer.

b. Timeliness

16. Information should be provided with sufficient frequency and timeliness to give a meaningful picture of the insurer. Timeliness requires insurers to report material information as soon as practicable after they become aware of it. In some circumstances, this will require ad hoc intra-period reporting.

17. The requirement for timeliness needs to be balanced against that for reliability. Disclosure of information may be delayed for a short period to allow for proper verification, but only where such delay would not significantly disadvantage users.

c. Accessibility

18. Information should be disseminated in ways best designed to bring it to the attention of market participants, but taking into account the relative costs of different methods of dissemination. Disclosure through electronic channels (e.g. internet) should be strongly encouraged.

d. Comprehensiveness

19. Information should be sufficiently comprehensive to enable market participants to form a well-rounded view of an insurer's financial condition and performance, business activities, and the risks related to those activities. In order to achieve this, information should be:

- sufficiently well-explained so that it is meaningful to a reader who is well-informed as to the inherent nature of insurance business but has no particular knowledge of the insurer except as derived from public disclosures;
- complete so that it covers all material circumstances of an insurer and, where relevant, those of the group of which it is a member; and
- both appropriately aggregated so that a proper overall picture of the insurer is presented and sufficiently disaggregated so that the effect of distinct material items may be separately identified.

20. Disclosure is not required where the information is not material.

e. Reliability

21. Information should faithfully represent that which it purports to represent, or could reasonably be expected to represent. In particular, it should, so far as practicable, reflect the economic substance of events and transactions as well as their legal form. Where the economic substance of an event or transaction is inconsistent with its legal form, the former should prevail. It should be verifiable, neutral (that is free from material error or bias) and complete in all material respects. Completeness is important since an omission can cause information to be false or misleading. Information that is audited may have increased reliability.

22. In many instances, insurers may have to balance the interests of reliability against those of relevance and timeliness. For example in some long-tail classes of insurance realistic projections as to the ultimate cost of incurred claims are highly relevant but, due to inherent uncertainties, not always fully reliable. Given the long-term nature of some insurance risks, reliability is a challenge. Expectations need to be managed so the market maintains a healthy scepticism of the reliability of the information disclosed.

f. Comparability

23. So far as practicable, information should be presented in accordance with any applicable generally accepted national and international standards and practices so as to aid comparisons between insurers. At present there are few, if any, applicable international standards for disclosure although important standards are under development.[1] Similarly national standards are at different stages of development in different jurisdictions but even in their more advanced forms do not purport to be fully prescriptive for all circumstances. It is important therefore that the methods and assumptions used in preparing the information are themselves adequately disclosed. While this will assist financial statement users in interpreting the information, it is recognized that, until international standards are developed and adopted uniformly, true comparability cannot be achieved.

g. Consistency

24. In order to assist in the identification of trends over time, an insurer should use methods and assumptions in the preparation of information which are consistent from period to period and disclose these. Where changes in methods and assumptions are made, the nature of such changes, and their effects, should be disclosed. Information should also be presented so as to facilitate the identification of patterns of development over time including providing comparative or corresponding figures from previous periods (e.g. by presenting loss triangulations).

3. What should be disclosed

25. Public information should at least include descriptions of:

a. financial position;

b. financial performance;

c. risk exposures and how they are managed;

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[1] The International Accounting Standards Board is charged with developing international accounting standards. IAS 1 defines overall considerations for financial statements generally (e.g. fair presentation, consistency, materiality and aggregation, etc.) and the minimum structure and content of the four basic financial statements (balance sheet, income statement, cash flow statement, and statement showing changes in equity.) IASB is currently working on a set of standards specifically for insurance contracts. For additional information, see www.iasc.org.uk.

d. the basis, methods and assumptions upon which information is prepared including the accounting policies (and comments on and the economic impact of any changes); and

e. basic business, management and corporate governance information.

a. Financial position

26. Information about the financial position of an insurer is useful in forming a view as to its ability to meet obligations and provide a return on investment to stakeholders, including participating (with-profits) policyholders. Such information includes descriptions of the nature and amounts of assets, liabilities and capital.

27. For assets the description might usefully include, where relevant:

- segmentation of the investment portfolio according to well-defined investment categories;
- the extent of the insurer's reliance on assets of a particular class or market sector, or from a particular counterparty;
- the bases and assumptions upon which assets are valued (measured);
- use of derivatives and the effect on the economic position of the investment portfolio;
- their appropriateness as a match for liabilities, including their ability to be realised (reflecting both credit quality and liquidity) and their duration;
- whether assets are pledged or have restrictions on their use (e.g. pledged as collateral or held in a participating fund); and
- the change in investments during the reporting period;

28. Similarly for liabilities it might, where relevant, include:

- the amount, timing and nature of liabilities, including contingent and prospective liabilities;
- the bases and assumptions upon which provisions for liabilities (including technical provisions) as well as other liabilities are valued (measured);
- segmentation of technical provisions according to lines of business and by category (e.g. provisions for premiums, provisions for claims);
- presentation of technical provisions both gross and net of reinsurance;
- use of derivatives and the effect on the economic position of the liabilities;
- statement of changes in the technical provisions (on a gross and net basis); and
- where the amount or timing of material liabilities is uncertain, the nature of that uncertainty and the circumstances in which the liability might crystallise or fall due earlier or later than expected or assumed.

29. And for capital, it might include:

- regulatory capital or solvency margin required;
- the amounts of the components and structure of capital; and
- the quality of capital, including any rights of redemption or entitlements to fixed or cumulative dividends or interest.

b. Financial performance

30. Information on an insurer's financial position alone is insufficient to enable market participants to take a prospective view of its ability to meet its obligations and provide a return on investment. That ability is determined by the insurer's financial position at the time the obligation falls due or the investment matures. This depends on both its current financial position and future financial performance.

31. Public disclosure of past financial performance, including in particular profitability and its variability over time, helps market participants to assess possible outcomes for future performance. However, as there are always reasons why the past is an imperfect predictor of the future, it is important that information on past financial performance is supplemented by information on present and prospective risk exposures, risk management strategies and practices, investment strategies, and basic business, management and corporate governance information.

32. Information on past financial performance includes information on the sources, and amounts, of income and expenditure and of cash flows. Relevant information might include:

- statements of profit and loss (including the technical underwriting account gross and net of reinsurance by broad lines of business) and of cash flows and key ratios derived from them including comparisons of earnings to capital employed and business volumes;
- statement of changes in equity showing gains and losses recognized directly in equity as well as capital transactions with and distributions to shareholders, and profit-sharing with policyholders;
- segmental reporting by material business line and geographical area including the technical underwriting account (gross and net of reinsurance) and historical patterns of claims development ('triangulations');
- returns on different categories of investments; and
- management's discussion and analysis of financial performance.

33. Within the statements of profit and loss and of cash flows and the segmental reporting, it is often helpful to market participants for insurers to:

- describe the nature and sources of income, expenditure and cash flows so as to help market participants form a view as to the quality and, in particular, potential volatility and sustainability of earnings;
- disclose amounts both gross and net of reinsurance so that the impact of reinsurance protections may be understood;

- report both claims incurred and paid so that changes in the pattern of claims settlement may be more readily identified; and
- identify the impact of acquisitions and lines of business discontinued during the reporting period so that trends may be more clearly discerned and the sustainability of earnings better understood.

34. Segmented reporting helps market participants understand the contribution of individual business lines/geographic segments to financial performance and to make comparisons between insurers. It allows market participants to assess the extent of diversification and exposure to high-risk business lines or geographical areas (e.g. exposure to areas prone to natural catastrophes or to liability insurance in litigious jurisdictions).

35. Management has a detailed knowledge of the business that outsiders cannot have. Therefore management can greatly assist market participants by discussing:

- the main factors that influenced an insurer's financial performance during the reporting period;
- differences in performance as compared to prior periods and to prior disclosed forecasts/projections ; and
- factors which they believe will have a significant influence on the insurer's future financial performance.

36. In particular the discussion might usefully identify past and prospective material changes in:

- underwriting strategy, including the channels of distribution of business;
- the nature, frequency and severity of claims;
- the potential for aggregation of claims from the same occurrence or series of occurrences arising from the same originating cause;
- the nature, level and collectability of reinsurance protections and the bases and assumptions used for setting technical provisions; and
- returns on different categories of investments.

c. Risk exposures and how they are managed

37. Disclosures on risk exposures, including strategies for managing risk and the effectiveness of those strategies, help market participants to assess an insurer's stability and viability including:

- the sensitivity of its earnings to potential changes in circumstances;
- whether returns are appropriate for the level of risk it has assumed; and
- ultimately its ability in times of stress to meet obligations and provide a return on investment.

38. Risk areas relevant to public disclosure typically might include:[2]

- **technical risks** (liability risks): i.e. various kinds of risk which are directly or indirectly associated with the technical or actuarial bases of calculation for premiums and technical provisions in both life and non-life insurance, as well as risks associated with operating expenses and excessive or uncoordinated growth;
- **investment risks** (asset risks): i.e. various kinds of risk which are directly or indirectly associated with the insurers' asset management; and
- **non-technical risks**: i.e. various kinds of risk which cannot in any suitable manner be classified as either technical risks or investment risks.

39. In discussing each risk area, an insurer should present sufficient qualitative and, where relevant and available, quantitative information to help market participants understand the nature of material exposure to risk, how it is managed and its potential impact. Special care needs to be taken to ensure that disclosures on risk are meaningful because risk exposures can change very quickly and strategies for dealing with risk have become more sophisticated, and thus more difficult to explain. Disclosures might usefully include descriptions of:

- the insurer's overall risk management philosophy and policy, including its risk appetite;
- how risks arise;
- how risks are managed and controlled;
- whether and how reinsurance, derivatives, securitisation and alternative risk transfer or mitigation mechanisms are used to manage risk; and
- how sensitive the risk measures disclosed are to changes in assumptions.

d. How information is prepared

40. So that public disclosure is meaningful to market participants, it should include an adequate description of how information is prepared, including methods applied and assumptions used. Such disclosure of methods and assumptions also assists market participants to make comparisons between insurers. Accounting and actuarial policies, practices and procedures differ not only between countries but also between insurers within the same country. Meaningful comparisons can thus only be made where there is adequate disclosure of how information is prepared. Similarly meaningful comparisons from one reporting period to another can only be made if the reader is informed how the methods and assumptions of preparation have changed and, if practicable, the impact of that change.

e. Basic business, management and corporate governance information

41. In order to help them evaluate public disclosures on financial position, financial performance and on risk and its management, market participants need fundamental

[2] Definitions from paragraph 5.2.5 of the IAIS Sub-Committee on Solvency and Actuarial Issues' Issues Paper "On Solvency, Solvency Assessments and Actuarial Issues" dated 15 March 2000.

information about an insurer's business, management and corporate governance. Such information helps market participants assess an insurer's efficiency and overall strength, future prospects and ability to respond to change.

42. Relevant disclosures might include:

- the insurer's position within the market in which it competes, its strategy and its progress toward achieving its strategic objectives;
- the board structure (e.g. the size of the board, the board committees and membership), senior management structure (i.e. responsibilities and reporting lines), the incentive structure (i.e. how compensation for executive and staff is set and the amounts of that compensation) and the overall corporate culture;
- the legal entity and lines of business structure of the insurer itself and, where applicable, of the group of which it is a member, including the organizational structure of the group, and material transactions between the insurer and related firms or individuals;
- the structure of ownership;
- significant strategic alliances and outsourcing arrangements entered into by the insurer with third parties;
- information regarding the future potential of identifiable intangible assets (e.g. capital expenditures on research and development, intellectual capital, new product development, training, and reputation); and
- the regulatory framework (e.g. the insurer must meet the specified standards of the regulator).

Guidance Paper No. 5

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE PAPER ON ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

OCTOBER 2004

This document was prepared by the Insurance Fraud Subcommittee,
in consultation with members and observers

It replaces the *Anti-Money Laundering Guidance Notes for Insurance Supervisors and Insurance Entities* (January 2002)

Guidance paper on anti-money laundering and combating the financing of terrorism

Contents

1. Introduction

1. The insurance sector[1] and other sectors of the financial services industry are potentially at risk of being misused for money laundering and the financing of terrorism. Criminals look for ways of concealing the illegitimate origin of funds. Persons involved in organising terrorist acts look for ways to finance these acts. The products and transactions of insurers can provide the opportunity to launder money or to finance terrorism.

2. Although its vulnerability is not regarded by the International Association of Insurance Supervisors (IAIS[2]) to be as high as for other sectors of the financial industry, the insurance sector is a possible target for money launderers and for those seeking resources for terrorist acts or for ways to process funds to accomplices. Insurers can be involved, knowingly or unknowingly, in money laundering and the financing of terrorism. This exposes them to legal, operational and reputational risks.[3] The insurance sector should therefore take adequate measures to prevent its misuse by money launderers and terrorists, and should address possible cases of money laundering and terrorist financing forthwith.

3. The IAIS has given anti-money laundering (AML) and combating the financing of terrorism (CFT) high priority. In October 2003 the IAIS approved and issued the *Insurance core principles and methodology*, which revised the core principles for the supervision of

1 The insurance sector includes insurers, reinsurance companies and intermediaries. The word "intermediaries" shall, in the context of this paper, mean agents, brokers and any other form of mediation or delegation of authority on behalf of an insurer.

2 All abbreviated terms are defined in the list of abbreviations in Appendix D.

3 Legal risk: the possibility that lawsuits, adverse judgements or contracts that turn out to be unenforceable disrupt or adversely affect the operations or condition of an insurer. Reputational risk: the potential that adverse publicity regarding an insurer´s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution. Operational risk: the risk arising from failure of systems, internal procedures and controls leading to financial loss. Operational risk also includes custody risk.

insurers. Compliance with the Insurance Core Principles is required for a supervisory system to be effective. In accordance with Insurance Core Principle 28 (see appendix B) the Recommendations of the Financial Action Task Force on Money Laundering (FATF) applicable to the insurance sector and to insurance supervision must be satisfied to reach this objective.

4. In June 2003 the FATF adopted a revised set of Forty Recommendations on AML/CFT, having adopted VIII Special Recommendations on Terrorist Financing to combat the financing of terrorism[4] in October 2001.

5. The IAIS considers the FATF Forty Recommendations 2003 on Money Laundering and the FATF VIII Special Recommendations on Terrorist Financing to be the international standards in the field of AML/CFT for insurance supervisors and the insurance sector.
According to FATF Recommendation 25 the "competent authorities [of each jurisdiction] should establish guidelines, and provide feedback which will assist financial institutions and designated non-financial businesses and professions in applying national measures to combat money laundering and terrorist financing, and in particular, in detecting and reporting suspicious transactions".

6. In light of the FATF Recommendations, the IAIS considers there is need for specific guidance for insurance supervisors and the insurance sector. This guidance paper is intended to provide such guidance and aims at tailoring the existing AML/CFT standards to the specific practices and features of the insurance sector.

7. The FATF Recommendations are applicable to the underwriting and placement of life insurance and other investment related insurance. This paper applies at a minimum to those insurers and intermediaries offering life insurance products or other investment related insurance.

8. The IAIS is concerned to ensure that the potential risks to types of insurance other than life insurance (non-life insurance and reinsurance) are also considered by insurance supervisors and insurers. Jurisdictions or the supervisor could decide to extend AML/CFT policies and guidance beyond the scope of the FATF Recommendations on the basis of a thorough analysis of the risk of money laundering or financing of terrorism for these other types of insurance. In the case of such a decision the regulator and/or supervisor concerned should determine the appropriate policies and guidance as described in this paper to adequately cover the risks involved. This does not imply that the full set of measures presented in this paper should be implemented in these cases. Where a jurisdiction/supervisor chooses to expand its AML/CFT policies and regulation to include non-life insurance and/or reinsurance, this paper offers a range of measures and procedures from which the jurisdiction/supervisor can determine the most effective. The type and extent of these policies and guidance imposed should be appropriate, having regard to these risks and the size of the business.

9. The same principles that apply to insurers should generally apply to insurance intermediaries.

10. Each insurance supervisor should consider whether to issue this guidance paper and/or its own guidance, at least equivalent to the standards in this paper, to insurers in its own jurisdiction. Each supervisor is responsible for issuing appropriate AML/CFT guidance.

4 These recommendations can be found on the FATF website (www.fatf-gafi.org). FATF Recommendations 4-6, 8-11, 13-15, 17, 21-23, 25, 29-32 and 40 as well as Special Recommendations IV, V, VII and the AML/CFT Methodology are specifically of importance for insurers and insurance supervisors.

11. This guidance paper is structured as follows:

- Sections 2 and 3 constitute a risk-based approach regarding the combating of money laundering and the financing of terrorism in the insurance sector.
- Section 2 explains the risk of money laundering and the financing of terrorism starting with a general description of the process of money laundering and the financing of terrorism and then explaining in more detail how this could be effected through the various types of insurance.
- Section 3 presents a set of measures and procedures to control the risks described in section 2. Section 3 discusses in more detail:
  - elements of customer due diligence (CDD)
  - reporting of suspicion
  - measures affecting the organisation and staff of the insurer.
- Section 4 is addressed to supervisors and deals with their application of the Insurance Core Principles, including the monitoring of compliance by insurers with AML/CFT standards and cooperation by supervisors with other organisations involved in AML/CFT. This section is specifically addressed to supervisors.

2. Money laundering and financing of terrorism in insurance

The process of money laundering and financing of terrorism

12. Money laundering is the processing of the proceeds of crime to disguise their illegal origin. Once these proceeds are successfully 'laundered' the criminal is able to enjoy these monies without revealing their original source. Money laundering can take place in various ways. Information on possible trends and techniques used by money launderers is collected by the FATF in the course of its annual typology exercise.[5]

13. Financing of terrorism can be defined as the wilful provision or collection, by any means, directly or indirectly, of funds with the intention that the funds should be used, or in the knowledge that they are to be used, to facilitate or carry out terrorist acts. Terrorism can be funded from legitimate income.

Vulnerabilities in insurance

14. Life insurance and non-life insurance can be used in different ways by money launderers and terrorist financiers. The vulnerability depends on factors such as (but not limited to) the complexity and terms of the contract, distribution, method of payment (cash or bank transfer) and contract law. Insurers should take these factors into account when assessing this vulnerability. This means they should prepare a risk profile of the type of business in general and of each business relationship.

15. Examples of the type of life insurance contracts that are vulnerable as a vehicle for laundering money or terrorist financing are products, such as:

- unit-linked or with profit single premium contracts
- single premium life insurance policies that store cash value
- fixed and variable annuities

5 More information on typologies can be found on the website of the FATF (www.fatf-gafi.org).

- (second hand) endowment policies.

16. When a life insurance policy matures or is surrendered, funds become available to the policyholder or other beneficiaries. The beneficiary to the contract may be changed – possibly against payment – before maturity or surrender, in order that payments are made by the insurer to a new beneficiary. A policy might be used as collateral to purchase other financial instruments. These investments in themselves may be merely one part of a sophisticated web of complex transactions with their origins elsewhere in the financial system.

17. Non-life insurance money laundering or terrorist financing can be seen through inflated or totally bogus claims, e.g. by arson or other means causing a bogus claim to be made to recover part of the invested illegitimate funds. Other examples include cancellation of policies for the return of premium by an insurer's cheque, and the overpayment of premiums with a request for a refund of the amount overpaid. Money laundering can also occur through under-insurance, where a criminal can say that he received compensation for the full amount of the damage, when in fact he did not.

Examples of how terrorism could be facilitated through property and casualty coverage, include use of worker's compensation payments to support terrorists awaiting assignment and primary coverage and trade credit for the transport of terrorist materials. This could also imply breach of regulations requiring the freezing of assets.

18. Money laundering and the financing of terrorism using reinsurance could occur either by establishing fictitious (re)insurance companies or reinsurance intermediaries, fronting arrangements and captives, or by the misuse of normal reinsurance transactions. Examples include:

- the deliberate placement via the insurer of the proceeds of crime or terrorist funds with reinsurers in order to disguise the source of funds
- the establishment of bogus reinsurers, which may be used to launder the proceeds of crime or to facilitate terrorist funding
- the establishment of bogus insurers, which may be used to place the proceeds of crime or terrorist funds with legitimate reinsurers.

19. Insurance intermediaries – independent or otherwise – are important for distribution, underwriting and claims settlement. They are often the direct link to the policyholder and therefore intermediaries should play an important role in anti-money laundering and combating the financing of terrorism. The FATF Recommendations allow insurers, under strict conditions, to rely on customer due diligence carried out by intermediaries. The same principles that apply to insurers should generally apply to insurance intermediaries. The person who wants to launder money or finance terrorism may seek an insurance intermediary who is not aware of, or does not conform to, necessary procedures, or who fails to recognise or report information regarding possible cases of money laundering or the financing of terrorism. The intermediaries themselves could have been set up to channel illegitimate funds to insurers. In addition to the responsibility of intermediaries, customer due diligence ultimately remains the responsibility of the insurer involved.[6]

20. Specific cases and examples of money laundering involving insurance are included in more detail in appendix C to this paper.

6 See FATF Recommendation 9

3. Control measures and procedures against money laundering and financing of terrorism

21. This section is structured as follows. After an introduction of the duty of vigilance:

- paragraphs 25-83 contain a description of the customer due diligence process
- paragraphs 84-88 describe measures and procedures for the reporting of suspicious transactions, and
- paragraphs 89-112 provide the arrangements that need to be made to the organisation of the insurer with respect to risk management, record keeping, screening and the training of staff.

The paragraphs on customer due diligence provide measures and procedures on:

- CDD in general and the link with the overall and client[7] acceptance policies of the insurer
- CDD when establishing a business relationship
- timing of identification and verification
- CDD in the course of the business relationship
- the methods of identification for individuals and for companies, partnerships and other institutions/arrangements
- enhanced CDD for higher risk customers and non-cooperative countries and territories (NCCTs) (including bearer policies, viatical arrangements, politically exposed persons (PEP) and new technologies)
- simplified CDD, and
- reliance on intermediaries and third parties.

22. Insurers should be constantly vigilant in deterring criminals from making use of them for the purposes of money laundering or the financing of terrorism. By understanding the risks of money laundering and the financing of terrorism, insurers are in a position to determine what can be done to control these risks, and which procedures and measures can be implemented effectively and efficiently.

23. For reasons of sound business practice and proper risk management insurers should already have controls in place to assess the risk of each business relationships. As customer due diligence is a business practice suitable not just for commercial risk assessment and fraud prevention[8] but also to prevent money laundering and the financing of terrorism, control measures should be linked to these existing controls. The concept of customer due diligence goes beyond the identification and verification of only the policyholder – it extends to identification of the potential risks of the whole business relationship.

24. The duty of vigilance consists mainly of the following elements:

- customer due diligence, including underwriting checks and verification of identity
- recognition and reporting of suspicious customers/transactions, and
- provisions affecting the organisation and the staff of the insurer, such as a compliance and audit environment, keeping of records, the recruitment of staff and training.

7 The term “client” in this paper refers to customers and beneficial owner unless a different meaning follows from the wording or context of the paragraphs involved.

8 See ICP 27 on Fraud

Performing due diligence on customers, beneficial owners and beneficiaries

25. Insurers should know the customers[9] with whom they are dealing. A first step in setting up a system of customer due diligence is to develop clear, written and risk based client acceptance policies and procedures, which among other things concern the types of products offered in combination with different client profiles. These policies and procedures should be built on the strategic policies of the board of directors of the insurer, including policies on products, markets and clients.

26. The insurer's strategic policies will determine its exposure to risks such as underwriting risk, reputational risk, operational risk, concentration risk[10] and legal risk. After determining the strategic policies, client acceptance policies should be established, taking account of risk factors such as the background and geographical base of the customer and/or beneficial owner[11] and the complexity of the business relationship (see paragraph 31 for other factors). This is why – as indicated above – control measures and procedures with respect to AML/CFT should be an integral part of the overall customer due diligence.

27. Insurers should be aware that, for example, they are more vulnerable to money laundering if they sell short term coverage by means of a single premium policy than if they sell group pensions to an employer with annuities to be paid after retirement. The former is more sensitive to money laundering and therefore calls for more intensive checks on the background of the client and the origin of the premium than the latter. Insurers should also be aware of requests for multiple policies to be taken out for premiums slightly below any publicised limits for performing checks, such as checks on the source of wealth.

28. Customer due diligence measures that should be taken by insurers include:[12]

- identifying the customer and verifying that customer's identity using reliable, independent source documents, data or information
- determining whether the customer is acting on behalf of another person, and then taking reasonable steps to obtain sufficient identification data to verify the identity of that other person
- identifying the (ultimate) beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner such that the insurer is satisfied that it knows who the beneficial owner is. For legal persons and arrangements insurers should take reasonable measures to understand the ownership and control structure of the customer
- obtaining information on the purpose and intended nature of the business relationship and other relevant factors
- conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the insurer's knowledge of the customer and/or beneficial owner, their business and risk profile, including, where necessary, the source of funds.

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9 Under normal conditions the term 'customer' refers to 'policyholder'.

10 Concentration risk: the risk that too much business is being conducted with persons or corporations belonging to the same conglomerate, group or geographical area.

11 According to the FATF Recommendations beneficial owner "refers to the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." For the purposes of this paper the expression 'beneficial owner' applies to the owner/controller of the policyholder as well as to the beneficiary to the contract.

12 FATF Recommendation 5

29. The extent and specific form of these measures may be determined following a risk analysis based upon relevant factors including the customer, the business relationship and the transaction(s). Enhanced due diligence is called for with respect to higher risk categories. Decisions taken on establishing relationships with higher risk customers and/or beneficial owners should be taken by senior management. Subject to national legal requirements insurers may apply reduced or simplified measures in the case of low risk categories.

30. Prior to the establishment of a business relationship, the insurer should assess the characteristics of the required product, the purpose and nature of the business relationship and any other relevant factors in order to create and maintain a risk profile of the customer relationship. Based on this assessment, the insurer should decide whether or not to accept the business relationship. As a matter of principle, insurers should not offer insurance to customers or for beneficiaries that obviously use fictitious names or whose identity is kept anonymous.

31. Factors to consider when creating a risk profile, which are not set out in any particular order of importance and which should not be considered exhaustive, include (where appropriate):

- type and background of customer and/or beneficial owner
- the customer's and/or beneficial owner's geographical base
- the geographical sphere of the activities of the customer and/or beneficial owner
- the nature of the activities
- the means of payment as well as the type of payment (cash, wire transfer, other means of payment)
- the source of funds
- the source of wealth
- the frequency and scale of activity
- the type and complexity of the business relationship
- whether or not payments will be made to third parties
- whether a business relationship is dormant
- any bearer arrangements
- suspicion or knowledge of money laundering, financing of terrorism or other crime.

32. The requirements for customer due diligence should apply to all new customers as well as – on the basis of materiality and risk – to existing customers and/or beneficial owners. As to the latter the insurer should conduct due diligence at appropriate times.[13] In insurance, various transactions or 'trigger events' occur after the contract date and indicate where due diligence may be applicable. These trigger events include claims notification, surrender requests and policy alterations, including changes in beneficiaries (see also paragraph 47).

33. The requirement for an insurer to pay special attention to all complex, unusually large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose is essential to both the establishment of a business relationship and to ongoing due diligence. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities and auditors.[14] In this respect "transactions" should be interpreted in a broad sense, meaning inquiries and applications for an insurance policy, premium payments, requests for changes in benefits, beneficiaries, duration, etc.

13 FATF Recommendation 5

14 FATF Recommendation 11

34. In the event of failure to complete verification of any relevant verification subject or to obtain information on the purpose and intended nature of the business relationship, the insurer should not conclude the insurance contract, perform the transaction, or should terminate the business relationship. The insurer should also consider making a suspicious transaction report (STR) to the financial intelligence unit (FIU).[15]

Establishing a business relationship

35. Before an insurance contract is concluded between customer and insurer there is already a pre-contractual business relationship between these two and possibly other parties. After a policy is taken out:

- the insurer covers a certain risk described in the contract and policy conditions
- certain transactions may take place such as premium payments, payments of advance or final benefits, and
- certain events may occur such as a change in cover or a change of beneficiaries.

36. The insurer will need to carefully assess the specific background, and other conditions and needs of the customer. This assessment is already being carried out for commercial purposes (determining the risk exposure of the insurer and setting an adequate premium) as well as for reasons of active client management. To achieve this, the insurer will collect relevant information, for example details of source of funds, income, employment, family situation, medical history, etc. This will lead to a customer profile which could serve as a reference to establish the purpose of the contract and to monitor subsequent transactions and events.

37. The insurer should realise that creating a customer profile is also of importance for AML/CFT purposes and therefore for the protection of the integrity of the insurer and its business.

38. In addition, the beneficial owner should also be identified and verified. For the purposes of this guidance paper the expression beneficial owner applies to the owner/controller of the policyholder as well as to the beneficiary to the contract.

39. With regard to reinsurance, due to the nature of the business and the lack of a contractual relationship between the policyholder and the reinsurance company, it is often impractical or impossible for the reinsurer to carry out verification of the policyholder or the beneficial owner. Therefore, for reinsurance business reinsurers should only deal with ceding insurers (1) that are licensed or otherwise authorised to issue insurance policies and (2) which have warranted or otherwise confirmed that they apply AML/CFT standards at least equivalent to those in this guidance paper, provided there is no information available to the contrary for instance from FATF and trade associations or from the reinsurers' visits to the premises of the insurer.

40. When the identity of customers and beneficial owners with respect to the insurance contract has been established the insurer is able to assess the risk to its business by checking customers and beneficial owners against internal and external information on known fraudsters or money launderers (possibly available from industry databases) and on known or suspected terrorists (publicly available on sanctions lists such as those published by the United Nations). The IAIS recommends that insurers use available sources of information when considering whether or not to accept a risk. Identification and subsequent

15 See paragraphs 84-88

verification will also prevent anonymity of policyholders or beneficiaries and the use of fictitious names.[16]

Timing of identification and verification

41. In principle identification and verification of customers and beneficial owners should take place when the business relationship with that person is established.[17] This means that (the owner / controller of) the policyholder needs to be identified and their identity verified before, or at the moment when, the insurance contact is concluded. Valid exceptions are mentioned in the following paragraphs.

42. Identification and verification of the beneficiary may take place after the insurance contract has been concluded with the policyholder, provided the money laundering risks and financing of terrorism risks are effectively managed. However, identification and verification should occur at or before the time of payout or the time when the beneficiary intends to exercise vested rights under the policy.[18]

43. Where a policyholder and/or beneficiary is permitted to utilise the business relationship prior to verification, financial institutions should be required to adopt risk management procedures concerning the conditions under which this may occur. These procedures should include measures such as a limitation of the number, types and/or amount of transactions that can be performed and the monitoring of large or complex transactions being carried out outside the expected norms for that type of relationship. Where the insurer has already commenced the business relationship and is unable to comply with the verification requirements it should terminate the business relationship and consider making a suspicious transaction report.

44. Examples of situations where a business relationship could be used prior to verification are:

- group pension schemes
- non-face-to-face customers
- premium payment made before the application has been processed and the risk accepted, and
- using a policy as collateral.

45. In addition, in the case of non-face-to-face business verification may be allowed after establishing the business relationship. However, insurers must have policies and procedures in place to address the specific risks associated with non-face-to-face business relationships and transactions[19] (see paragraphs 71-73).

Transactions and events in the course of the business relationship

46. The insurer should perform ongoing due diligence on the business relationship. In general the insurer should pay attention to all requested changes to the policy and/or exercise of rights under the terms of the contract. It should assess if the change/transaction does not fit the profile of the customer and/or beneficial owner or is for some other reason unusual or suspicious. Enhanced due diligence is required with respect to higher risk

16 FATF Recommendation 5

17 FATF Recommendation 5

18 Interpretative Note no 6 to FATF Recommendation 5

19 FATF Recommendation 8

categories. The CDD program should be established in such a way that the insurer is able to adequately gather and analyse information.

47. Examples of transactions or trigger events after establishment of the contract that require CDD are:

- a change in beneficiaries (for instance, to include non-family members, or a request for payments to be made to persons other than beneficiaries)
- a change/increase of insured capital and/or of the premium payment (for instance, which appear unusual in the light of the policyholder's income or where there are several overpayments of policy premiums after which the policyholder requests that reimbursement is paid to a third party)
- use of cash and/or payment of large single premiums
- payment/surrender by a wire transfer from/to foreign parties
- payment by banking instruments which allow anonymity of the transaction
- change of address and/or place of residence of the policyholder, in particular, tax residence
- lump sum top-ups to an existing life insurance contract
- lump sum contributions to personal pension contracts
- requests for prepayment of benefits
- use of the policy as collateral/security (for instance, unusual use of the policy as collateral unless it is clear that it is required for financing of a mortgage by a reputable financial institution)
- change of the type of benefit (for instance, change of type of payment from an annuity to a lump sum payment)
- early surrender of the policy or change of the duration (where this causes penalties or loss of tax relief)
- request for payment of benefits at the maturity date.

48. The above list is not exhaustive. Insurers should consider other types of transactions or trigger events which are appropriate to their type of business.

49. Occurrence of these transactions and events does not imply that (full) customer due diligence needs to be applied. If identification and verification have already been performed, the insurer is entitled to rely on this unless doubts arise about the veracity of that information it holds.[20] As an example, doubts might arise if benefits from one policy of insurance are used to fund the premium payments of another policy of insurance.

Methods of identification and verification

50. This guidance paper does not seek to specify what, in any particular case, may or may not be sufficient evidence to complete verification. It does set out what, as a matter of good practice, may reasonably be expected of insurers. Since, however, this guidance paper is neither mandatory nor exhaustive, there may be cases where an insurer has properly satisfied itself that verification has been achieved by other means which it can justify to the appropriate authorities as reasonable in the circumstances.

51. The best possible identification documentation should be obtained from each verification subject. "Best possible" means that which is the most difficult to replicate or acquire unlawfully because of its reputable and/or official origin.

20 Interpretative Note no 5 to FATF Recommendation 5

Individuals

52. The following personal information should be considered:

- full name(s) used
- date and place of birth
- nationality
- current permanent address including postcode/zipcode[21]
- occupation and name of employer (if self-employed, the nature of the self-employment), and
- specimen signature of the individual.

53. It is recognised that different jurisdictions have different identification documents. In order to establish identity it is suggested that the following documents may be considered to be the best possible, in descending order of acceptability:

- current valid passport; or
- national identity card.

54. However, some jurisdictions do not have national identity cards and many individuals do not possess passports. Where appropriate the jurisdictions or insurance supervisors should compile their own list in accordance with local conditions.

55. Original documents should be signed by the individual and if the individual is met face-to-face, the documents should preferably bear a photograph of the individual. Where copies of documents are provided, appropriate authorities and professionals may certify the authenticity of the copies.

56. Documents which are easily obtained in any name should not be accepted uncritically. These documents include birth certificates, an identity card issued by the employer of the applicant even if bearing a photograph, credit cards, business cards, driving licences (not bearing a photograph), provisional driving licences and student union cards.

Legal persons, companies, partnerships and other institutions/arrangements

57. The types of measures normally needed to perform CDD on legal persons, companies, partnerships and other institutions/arrangements satisfactorily require identification of the natural persons with a controlling interest and the natural persons who comprise the mind and management of the legal person or arrangement. Where the customer or the owner of the controlling interest is a public company that is subject to regulatory disclosure requirements, it is not necessary to identify and verify the identity of any shareholder of that company.

58. FATF Recommendation 5 requires, where customers and/or beneficial owners are legal persons or legal arrangements, the insurers to:

- verify that any person purporting to act on behalf of the customer and/or beneficial owner is so authorised and identify and verify the identity of that person
- verify the legal status of the legal person or legal arrangement, e.g. by obtaining proof of incorporation or similar evidence of establishment or existence, and
- form an understanding of the ownership and control structure of the customer and/or beneficial owner.

21 In this context "current permanent address" means the verification subject's actual residential address, as it is an essential part of identity.

59. Where trusts or similar arrangements are used, particular care should be taken in understanding the substance and form of the entity. Where the customer is a trust, the insurer should verify the identity of the trustees, any other person exercising effective control over the trust property, the settlors and the beneficiaries. Should it not be possible to verify the identity of the beneficiaries when the policy is taken out, verification must be carried out prior to any payments being made.

60. When dealing with the identification and verification of companies, trust and other legal entities the insurer should be aware of vehicles, corporate or otherwise, that are known to be misused for illicit purposes.

61. Sufficient verification should be undertaken to ensure that the individuals purporting to act on behalf of an entity are authorised to do so.

62. The following documents or their equivalent should be considered:

- certificate of incorporation
- the name(s) and address(es) of the beneficial owner(s) and/or the person(s) on whose instructions the signatories of the customer are empowered to act
- constitutional documents e.g. memorandum and articles of association, partnership agreements
- copies of powers of attorney or other authorities given by the entity.

63. In all transactions undertaken on behalf of an employer-sponsored pension or savings scheme the insurer should, at a minimum, undertake verification of the principal employer and the trustees of the scheme (if any).

64. Verification of the principal employer should be conducted by the insurer in accordance with the procedures for verification of institutional applicants for business. Verification of any trustees of the scheme will generally consist of an inspection of the relevant documentation, which may include:

- the trust deed and/or instrument and any supplementary documentation
- a memorandum of the names and addresses of current trustees (if any)
- extracts from public registers
- references from professional advisers or investment managers.

65. As legal controls vary between jurisdictions, particular attention may need to be given to the place of origin of such documentation and the background against which it is produced.

Enhanced measures with respect to higher risk customers and non-cooperative countries and territories

66. Enhanced CDD measures should apply to all higher risk business relationships, clients and transactions. This includes both high risk business relationships assessed by the insurer, based on the customer's individual risk situation, and the types of business relationships mentioned in the following paragraphs.

67. With regard to enhanced due diligence, in general the insurer should consider which of the following, or possible additional measures, are appropriate:

- certification by appropriate authorities and professionals of documents presented

- requisition of additional documents to complement those which are otherwise required
- performance of due diligence on identity and background of the customer and/or beneficial owner, including the structure in the event of a corporate customer
- performance of due diligence on source of funds and wealth
- obtaining senior management approval for establishing business relationship
- conducting enhanced ongoing monitoring of the business relationship.

Bearer policies

68. Bearer policies are insurance contract that require the insurer to pay funds to the person(s) holding the policy document or to whom the entitlement to the benefit(s) is endorsed without knowledge or consent of the insurer. This type of policy does not exist in every jurisdiction but, where it does, it could serve as a financial instrument that can easily be exchanged from person to person without the endorsees being identified. Identification and verification by the insurer would only occur at the policy's maturity when the benefits are being claimed. From the point of view of AML and CFT the use of bearer policies should be discouraged. Where bearer policies are nevertheless permitted in a jurisdiction the insurer should perform appropriate enhanced CDD as specified above.

Viatical arrangements

69. Where a policyholder becomes seriously or terminally ill, he may decide to transfer the entitlement to the benefits of a life insurance policy after his death to a third party in order to receive funds before his death. In some jurisdictions there are "viatical" companies that purchase and sell these entitlements. In these cases similar risks exist as described under "bearer policies". Where viatical arrangements are allowed in a jurisdiction, supervisory overview or regulation is recommended. The insurer who needs to pay funds to a viatical company should perform enhanced CDD as specified above including the identification and verification of the viatical company and its beneficial owners.

Politically exposed persons[22]

70. The FATF Recommendations require additional due diligence measures in relation to PEPs.[23] For this purpose insurers should:

- have appropriate risk management systems to determine whether the customer is a PEP. The board of directors of the insurer must establish a client acceptance policy with regard to PEPs, taking account of the reputational and other relevant risks involved.
- obtain senior management approval for establishing business relationships with such customers
- take reasonable measures to establish the source of wealth and source of funds, and
- conduct enhanced ongoing monitoring of the business relationship.

New or developing technologies

71. New or developing technologies can be used to market insurance products. E-commerce or sales through the internet is an example of this. Although for this type of non-

22 According to the FATF Recommendations Politically Exposed Persons (PEPs) are "individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories."

23 FATF Recommendation 6

face-to-face business verification may be allowed after establishing the business relationship, the insurer should nevertheless complete verification.

72. Although a non-face-to-face customer can produce the same documentation as a face-to-face customer, it is more difficult to verify their identity. Therefore, in accepting business from non-face-to-face customers an insurer should use equally effective identification procedures as those available for face-to-face customer acceptance, supplemented with specific and adequate measures to mitigate the higher risk.

73. Examples of such risk mitigating measures are:

- certification by appropriate authorities and professionals of the documents provided
- requisition of additional documents to complement those which are required for face-to-face customers
- independent contact with the customer by the insurer
- third party introduction, e.g. by an intermediary subject to the criteria established in paragraphs 78-83
- requiring the first payment to be carried out through an account in the customer's name with a bank subject to similar CDD standards.

Non-cooperative countries and territories

74. Compliance by jurisdictions with the FATF Recommendations is periodically assessed by international bodies.[24] Jurisdictions that do not sufficiently apply the FATF Recommendations could be listed by the FATF as NCCTs. In specific circumstances, jurisdictions may be asked to impose appropriate countermeasures.[25] Insurers should give special attention, especially in underwriting and claims settlement, to business originating from jurisdictions which do not sufficiently apply the FATF Recommendations.

Simplified customer due diligence

75. In general, the full range of CDD measures should be applied to the business relationship. However, if the risk of money laundering or the financing of terrorism is lower (based on the insurer's own assessment), and if information on the identity of the customer and the beneficial owner is publicly available, or adequate checks and controls exist elsewhere in national systems it could be reasonable for insurers to apply, subject to national legislation, simplified or reduced CDD measures when identifying and verifying the identity of the customer, the beneficial owner[26] and other parties to the business relationship.

76. Insurers should bear in mind that the FATF lists the following examples of customers where simplified or reduced measures could apply:[27]

- financial institutions – where they are subject to requirements to combat money laundering and the financing of terrorism consistent with the FATF Recommendations, and are supervised for compliance with those controls
- public companies that are subject to regulatory disclosure requirements
- government administrations or enterprises.[28]

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24 Mutual evaluations under the aegis of the FATF or the Financial Sector Assessment Program by IMF / World Bank.

25 FATF Recommendation 21

26 Interpretative Note no 9 to FATF Recommendation 5

27 Jurisdictions and/or supervisors should assess from an AML and CFT perspective whether the specific circumstances in their insurance sector allow for the simplified or reduced CDD measures, as presented in this and the following paragraph, to be applied.

28 Interpretative Note no 10 to FATF Recommendation 5

77. Furthermore, the FATF states that simplified CDD or reduced measures could also be acceptable for various types of products or transactions such as (examples only):

- life insurance policies where the annual premium is no more than USD/€ 1000 or a single premium of no more than USD/€ 2500
- insurance policies for pension schemes if there is no surrender clause and the policy cannot be used as collateral
- a pension, superannuation or similar scheme that provides retirement benefits to employees, where contributions are made by way of deduction from wages and the scheme rules do not permit the assignment of a member's interest under the scheme.[29]

Reliance on intermediaries and third parties[30]

78. Depending on the legislation of the jurisdictions in which the insurer operates, it may be allowed to rely on intermediaries and third parties to perform the following CDD elements:[31]

- identifying the customer and verifying that customer's identity using reliable, independent source documents, data or information
- identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner to the extent the intermediary or third party is satisfied that they know who the beneficial owner is, including taking reasonable measures to understand the ownership and control structure of the customer, and
- obtaining information on the purpose and intended nature of the business relationship.

79. Where such reliance is permitted, the following criteria should be met:

- the insurer should immediately obtain the necessary information concerning the above mentioned elements. Insurers should take adequate steps to satisfy themselves that copies of identification data and other relevant documentation relating to the CDD requirements will be made available from the intermediaries and third parties upon request without delay. Insurers should be satisfied with the quality of the due diligence undertaken by the intermediaries and third parties.
- the insurer should satisfy itself that the intermediaries and third parties are regulated and supervised, and have measures in place to comply with CDD requirements in line with FATF Recommendations 5 and 10.

80. Where such reliance is permitted, the ultimate responsibility for customer and/or beneficial owner identification and verification remains with the insurer relying on the intermediaries or third parties. The checks by the insurer as indicated in the previous paragraph do not have to consist of a check of every individual transaction by the intermediary or third party. The insurer should be satisfied that the AML and CFT measures are implemented and operating adequately.

81. Insurers should satisfy the above provisions by including specific clauses in the agreements with intermediaries/third parties or by any other appropriate means. These clauses should include commitments for the intermediaries/third parties to perform the necessary CDD measures, granting access to client files and sending (copies of) files to the

29 Interpretative Note no 12 to FATF Recommendation 5

30 The following paragraphs 78-83 do not apply to outsourcing or agency relationships other than relationships with insurance agents and brokers.

31 FATF Recommendation 9

insurer upon request without delay. The agreement could also include other compliance issues such as reporting to the FIU and the insurer in the case of a suspicious transaction. It is recommended that insurers use application forms to be filled out by the customers and/or intermediaries/third parties that include information on identification of the customer and/or beneficial owner as well as the method used to verify their identity.

82. Each jurisdiction should determine in which jurisdictions the intermediaries and third parties that meet the conditions can be based. Insurers should inform themselves as to which jurisdictions are considered suitable taking into account information available on whether those jurisdictions adequately apply the FATF Recommendations.[32]

83. The insurer should undertake and complete its own verification of the customer and beneficial owner if it has any doubts about the ability of the intermediary or the third party to undertake appropriate due diligence.

Reporting of suspicious transactions to the Financial Intelligence Unit[33]

84. If an insurer suspects, or has reasonable grounds to suspect, that funds are the proceeds of a criminal activity or are related to terrorist financing it should be required to report its suspicions promptly to the FIU.[34] [35] [36]

85. An important pre-condition of recognition of a suspicious transaction is for the insurer to know enough about the customer and business relationship to recognise that a transaction, or a series of transactions, is unusual.

86. Suspicious transactions might fall into one or more of the following examples of categories:

- any unusual financial activity of the customer in the context of his own usual activities
- any unusual transaction in the course of some usual financial activity
- any unusually linked transactions
- any unusual or disadvantageous early redemption of an insurance policy
- any unusual employment of an intermediary in the course of some usual transaction or financial activity e.g. payment of claims or high commission to an unusual intermediary
- any unusual method of payment
- any involvement of any person subject to international sanctions.

87. Verification, once begun, should be pursued either to a conclusion or to the point of refusal. If a prospective policyholder does not pursue an application, this may be considered suspicious in itself.

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32 See FATF Recommendation 9, last sentence. NCCTs should not be considered to be suitable jurisdictions.

33 In this paper "suspicious transaction" includes suspicious activities.

34 FATF Recommendation 13

35 Pursuant to FATF Recommendation 26 countries should establish a FIU that serves as a national centre for the receiving (and, as permitted, requesting), analysis and dissemination of suspicious transaction reports (STR) and other information regarding potential money laundering or terrorist financing. The FIU should have access, directly or indirectly, on a timely basis to the financial, administrative and law enforcement information that it requires to properly undertake its functions, including the analysis of STR.

36 According to FATF Recommendation 14 insurers, their directors, officers and employees should be protected by legal provisions from criminal and civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report their suspicions in good faith to the FIU, even if they did not know precisely what the underlying criminal activity was, and regardless of whether illegal activity actually occurred.

88. Insurers, their directors, officers and employees should not disclose the fact that a suspicious transaction report or related information is being reported, or has been reported, to the FIU.[37] The insurer should be aware that if it performs additional CDD because of suspicions it could unintentionally tip off the policyholder, beneficiary or other subjects of the suspicious transaction report. The insurer could then decide not to pursue these due diligence activities but to file a suspicious transaction report.

Organisation and staff

Risk management arrangements

89. Insurers should have in place programmes and systems to prevent money laundering and the financing of terrorism. Each insurer's programme should be sufficiently robust to effectively and efficiently handle the volume of information processed by that insurer. The programmes and systems should constitute an operational, practical and precise approach for dealing with money laundering and terrorist financing. These programmes and systems should be adapted to the group structure, organisational structure (e.g. joint back office), responsibility structure and products and market conditions.

90. These programmes should include:

- the development of internal policies, procedures and controls which, inter alia, should cover:
  - CDD, the detection of unusual or suspicious transactions and the reporting obligation, and the communication of these policies, procedures and controls to the employees
  - appropriate compliance management arrangements, e.g. at a minimum the designation of an AML/CFT compliance officer
  - record keeping arrangements, and
  - adequate screening procedures to ensure high standards when hiring employees
- an ongoing employee training programme
- an adequately resourced and independent audit function to test compliance (e.g. through sample testing) with these policies, procedures, and controls.[38]

91. The development of policies, procedures and controls enables the insurer to comply with legislation and to determine the desired standard of CDD for its own organisation. In order to be able to verify whether the insurer works in compliance with its internal policies, procedures and controls, an audit function should be in place. It is of importance that the audit function is independent and, if applicable, that the auditor has direct access and reports directly to management and the board of directors.

92. It is important that the board of directors and senior management of the insurer establish and support the developed internal policies, procedures and controls and the implementation and adherence thereto. Implementation of internal AML/CFT measures must constitute a relevant priority to insurers. In addition, the board of directors and senior management of an insurer should be kept regularly informed of all significant matters relating to AML/CFT measures and whether the insurer is suspected of being used to launder money or to finance terrorism. This information should be used to evaluate the effectiveness of the programmes and to take appropriate action.

37 FATF Recommendation 14

38 FATF Recommendation 15 and *Methodology for assessing compliance with anti-money laundering and combating the financing of terrorism standards* 2004

93. Compliance management arrangements should include the appointment of a compliance officer[39] at management level.[40] The compliance officer should be well versed in the different types of products and transactions which the institution handles and which may give rise to opportunities for money laundering and the financing of terrorism. On receipt of a report from a member of staff concerning a suspicious customer or suspicious transaction the compliance officer should determine whether the information contained in such a report supports the suspicion. The compliance officer should verify the details in order to determine whether the insurer should submit a report to the FIU. The compliance officer should keep a register of all reports to the FIU and a separate register of all reports made to him by staff.[41]

94. Insurers should ensure that:

- there is a clear procedure for staff to report suspicions of money laundering and the financing of terrorism without delay to the compliance officer
- there is a clear procedure for reporting suspicions of money laundering and the financing of terrorism without delay to the FIU, and
- all staff know to whom their suspicions should be reported.

95. Insurers should ensure that the principles applicable to insurers also apply to branches and majority owned subsidiaries located abroad, especially in jurisdictions which do not or insufficiently apply the FATF Recommendations. Thus, branches and majority owned insurance subsidiaries should observe appropriate AML/CFT measures which are consistent with the home jurisdiction requirements. Where local applicable laws and regulations prohibit this implementation, the supervisor in the jurisdiction of the parent institution should be informed by the insurer that it cannot apply the FATF Recommendations.[42]

96. It is recommended that insurers and other financial institutions should liaise to exchange information on both trends and risks in general and on concrete cases , subject to their obligations concerning privacy and data protection. The IAIS encourages trade associations to promote and/or facilitate this exchange of information.

Record keeping

97. Insurers should keep records on the risk profile of each customer and/or beneficial owner and the data obtained through the CDD process (e.g. name, address, the nature and date of the transaction, the type and amount of currency involved, and the type and identifying number of any account involved in the transaction), official identification documents (such as passports, identity cards or similar documents) and the account files and business correspondence, for at least five years after the end of the business relationship.[43] For insurers this implies that there are prescribed periods for keeping relevant records for at least five years after the expiry of policies.

98. Insurers should maintain, for at least five years after the business relationship has ended, all necessary records on transactions, both domestic and international, and be able to comply swiftly with information requests from the competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amount and

39 The term ‚compliance officer' may in some jurisdictions be referred to as the money laundering reporting officer.

40 Interpretative notes to FATF Recommendation 15

41 Including agency and temporary staff.

42 FATF Recommendation 22

43 FATF Recommendation 10

types of currency involved if any) so as to provide, if necessary, evidence for prosecution of criminal activity.[44]

99. Insurers should ensure that documents, data or information collected under the CDD process is kept up-to-date and relevant by undertaking reviews of existing records, particularly for higher risk categories of clients or business relationships.

100. Insurers should ensure that they have adequate procedures:

- to access initial proposal documentation including, where these are completed, the client financial assessment, client needs analysis, copies of regulatory documentation, details of the payment method, illustration of benefits, and copies of documentation in support of verification by the insurers
- to access all post-sale records associated with the maintenance of the contract, up to and including maturity of the contract, and
- to access details of the maturity processing and/or claim settlement including completed "discharge documentation".

101. Records should be available to domestic competent authorities upon appropriate authority.[45]

Screening of staff [46]

102. Staff should have the level of competence necessary for performing their duties. Insurers should ascertain whether they have the appropriate ability and integrity to conduct insurance activities, taking into account potential conflicts of interests and other relevant factors, for instance the financial background of the employee.

103. Insurers should identify the key staff within their organisation with respect to AML/CFT and define fit and proper requirements which these key staff should possess. Paragraphs 109, 111 and 112 provide a description of relevant positions.

104. The responsibility for initial and on-going assessment of the fitness and propriety of staff lies with the insurer.[47] The procedures concerning the assessment of whether staff meet the fit and proper requirements should include the following:

- verification of the identity of the person involved, and
- verification of whether the information and references provided by the employee are correct and complete.

105. Decisions regarding the employment of key staff should be based on a well founded judgement as to whether they meet the fit and proper requirements.

106. Insurers should keep records on the identification data obtained about key staff. The records should demonstrate the due diligence performed in relation to the fit and proper requirements.

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44 FATF Recommendation 10

45 FATF Recommendation 10

46 This section deals with the assessment of staff other than directors and managers that are subject to fit and proper tesing pursuant to Insurance Core Principle 7 ("Suitability of persons") and the IAIS *Guidance paper on fit and proper principles and their application*.

47 Insurance Core Principle 7

Training of staff

107. Insurers' staff should receive initial and ongoing training on relevant AML/CFT legislation, regulations, guidance and the insurers' own AML/CFT policies and procedures. Although each insurer should decide for itself how to meet the need to train members of its staff in accordance with its particular legal, regulatory and commercial requirements, the programme will at a minimum include:

- a description of the nature and processes of laundering and terrorist financing, including new developments and current money laundering and terrorist financing techniques, methods and trends
- a general explanation of the underlying legal obligations contained in the relevant laws, and
- a general explanation of the insurers' AML/CFT policy and systems, including particular emphasis on verification and the recognition of suspicious customers/transactions and the need to report suspicions to the compliance officer.

108. Employees who, due to their assigned work, need more specific training can be divided into two categories.

109. The first category of employees is those staff who deal with:

- new business and the acceptance – either directly or via intermediaries – of new policyholders, such as sales persons
- the settlement of claims, and
- the collection of premiums or payments of claims.

110. They need to be made aware of their legal responsibilities and the AML/CFT policies and procedures of the insurer, in particular the client acceptance policies and all other relevant policies and procedures, the requirements of verification and records, the recognition and reporting of suspicious customers/transactions and suspicion of the financing of terrorism. They also need to be aware that suspicions, should be reported to the compliance officer in accordance with AML/CFT systems.

111. A higher level of instruction covering all aspects of AML/CFT policy and procedure should be provided to the second category of staff, including directors and senior management with the responsibility for supervising or managing staff, and for auditing the system. The training should include:

- their responsibility regarding AML/CFT policies and procedures
- relevant laws, including the offences and penalties arising
- procedures relating to the service of production and restraint orders (to stop writing business)
- internal reporting procedures, and
- the requirements for verification and record keeping.

112. In addition to the training mentioned in the previous paragraphs, the compliance officer should receive in-depth training concerning all aspects of all relevant legislation and guidance and AML/CFT policies and procedures. The compliance officer will require extensive initial and continuing instruction on the validation and reporting of suspicious customers/transactions and freezing assets in accordance with legislation.

4. Role of the supervisor

113. Supervisory authorities, in conjunction with law enforcement authorities and in cooperation with other supervisors, must adequately supervise insurers for AML/CFT purposes in order to assess their ability to prevent and counter such threats.

Application of relevant insurance core principles

114. According to the IAIS Insurance Core Principles a sound regulatory and supervisory system is necessary for maintaining efficient, safe, fair and stable insurance markets. The FATF Recommendations emphasise that jurisdictions should ensure that financial institutions are subject to adequate regulation and supervision, and are effectively implementing the FATF Recommendations. According to FATF Recommendation 23, the regulatory and supervisory measures that apply for prudential purposes and which are also relevant to money laundering, should apply in a similar manner for AML/CFT.

115. Therefore, the supervisor should be aware of the relevance for AML/CFT purposes of the duties it carries out to comply with the Insurance Core Principles. By way of example, the application of standards on corporate governance issues; approval of control and ownership of the insurer and changes thereto; suitability of significant owners, board members and senior management (fit and proper testing[48]); and the internal control measures of the insurers are relevant in this context.

116. Attention to money laundering and the financing of terrorism with respect to supervisory duties will enhance international efforts to prevent the risks of misuse of insurers. It will raise the awareness of the board of directors and management of insurers, help in keeping internal procedures effective, and prevent criminals or their associates from holding or being the beneficial owner of a significant or controlling interest or holding a management function in an insurer.

117. The supervisor should take account of these risks at each phase of the supervisory process, at the licensing stage and in the course of ongoing supervision.

118. The supervisory authority should have adequate powers, including the authority to conduct on-site inspections, to monitor and ensure compliance by insurers with requirements to prevent money laundering and the financing of terrorism. It should be authorised to compel production of any information from insurers that is relevant to monitoring such compliance, and to impose adequate administrative sanctions for failure to comply with such requirements.[49]

119. The supervisor should periodically review the effectiveness of its systems to prevent money laundering and the financing of terrorism. This review may include liaison with other competent authorities (see paragraphs 126, 127 and 128).

120. The supervisor should be provided with adequate financial, human and technical resources to prevent or assess the insurance sector's ability to prevent money laundering and the financing of terrorism. It should have in place processes to ensure its staff are of high integrity and have adequate and relevant training for example with respect to AML/CFT

48 In accordance with ICP 7 ("Suitability of persons") and the IAIS *Guidance paper on fit and proper principles and their application*.

49 FATF Recommendation 29

legislation, money laundering and terrorist financing typologies and techniques used to monitor compliance with AML/CFT standards by insurers.[50]

Monitoring compliance

121. The supervisor should monitor adherence by insurers with AML/CFT regulations, this guidance paper and any guidance issued by the supervisor as well as policy and procedures set by management.

122. When conducting on-site inspections the supervisor should consider the insurer's policies and systems as a whole, inter alia by checking policy statements, procedures, books and records, manuals, training programmes, as well as the adequacy of operations, by checking at random or on a risk basis client files for identification and verification documentation, internal reports to the compliance officer on suspicious transactions and formal STRs to the FIU.

123. The supervisor should take appropriate corrective measures or sanctions and, if appropriate, refer to law enforcement agencies in cases where there is a lack of compliance by an insurer.

Cooperation

124. FATF Recommendation 31 states that jurisdictions should ensure that policy makers, the FIU, law enforcement agencies and supervisors have effective mechanisms in place which enable them to cooperate and, where appropriate, coordinate domestically with each other concerning the development and implementation of policies and activities to prevent money laundering and the financing of terrorism.

125. FATF Recommendation 40 states that jurisdictions should ensure that their competent authorities, including the supervisors, provide the widest possible range of international cooperation to their foreign counterparts. There should be clear and effective gateways to facilitate the prompt and constructive exchange directly between counterparts, either spontaneously or upon request, of information relating to both money laundering and the underlying predicate offences.

126. The IAIS encourages the supervisor to take all necessary steps to cooperate with the other relevant authorities.

127. It is recommended that the supervisor appoints within its office a contact for AML/CFT issues and to liaise with other national authorities to promote an efficient exchange of information on both trends and risks in general, policy issues and on concrete cases. Contact with the national FIU and law enforcement agencies is recommended to highlight issues of compliance by insurers and to obtain feedback on reported cases.

128. At an international level these contacts could liaise with fellow insurance supervisors to share information on trends and typologies and to deal with incidents with an international dimension.

129. FATF Recommendation 40 states that exchange of information should be permitted without unduly restrictive conditions. In particular:

50 FATF Recommendation 30

- the competent authorities, including the supervisor, should not refuse a request for assistance on the sole ground that the request is also considered to involve fiscal matters
- countries should not invoke laws that require financial institutions to maintain secrecy or confidentiality as a ground for refusing to provide cooperation
- the competent authorities, including the supervisor, should be able to conduct inquiries and, where possible, investigations on behalf of foreign counterparts.

130. The supervisor should establish controls and safeguards so that information exchanged by competent authorities is used only in an authorised manner, consistent with their obligations concerning privacy and data protection.[51]

131. Depending on the type of competent authorities involved and the nature and purpose of the cooperation, different channels can be appropriate for the exchange of information. Examples of mechanisms or channels that are used to exchange information include bilateral or multilateral agreements or arrangements, memoranda of understanding, exchanges on the basis of reciprocity, or liaison through appropriate international or regional organisations.[52]

51 FATF Recommendation 40

52 Interpretative notes to Recommendation 40

Appendix A – References

References

- Financial Action Task Force (FATF), *Special Recommendations on Terrorist Financing*, October 2001

- FATF, *Report on Money Laundering Typologies*, 2002-2003

- FATF, *The Forty Recommendations*, June 2003

- FATF, *Report on Money Laundering and Terrorist Financing Typologies*, 2003-2004

- FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the 8 Special Recommendations*, February 2004

- International Association of Insurance Supervisors (IAIS), *Insurance Core Principles and Methodology*, October 2003

- IAIS, *Anti-Money Laundering Guidance Notes for Insurance Supervisors and Insurance Entities*, January 2002

Appendix B – IAIS Insurance Core Principle on AML/CFT

ICP 28 Anti-money laundering, combating the financing of terrorism (AML/CFT)

The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).

Explanatory note

28.1. In most IAIS member jurisdictions, money laundering and financing of terrorism are criminal acts under the law. Money laundering is the processing of criminal proceeds to disguise their illegal origin. The financing of terrorism involves the direct or indirect provision of funds, whether lawfully or unlawfully obtained, for terrorist acts or to terrorist organisations.

28.2. Insurers and intermediaries, in particular those insurers and intermediaries offering life insurance or other investment related insurance could be involved, knowingly or unknowingly, in money laundering and financing of terrorism. This exposes them to legal, operational and reputational risks. Supervisory authorities, in conjunction with law enforcement authorities and in co-operation with other supervisors, must adequately supervise insurers and intermediaries for AML/CFT purposes to prevent and counter such activities.

Essential criteria

a. The measures required under the AML/CFT legislation and the activities of the supervisors should meet the criteria under those FATF Recommendations applicable to the insurance sector.[53]

b. The supervisory authority has adequate powers of supervision, enforcement and sanction in order to monitor and ensure compliance with AML/CFT requirements. Furthermore, the supervisory authority has the authority to take the necessary supervisory measures to prevent criminals or their associates from holding or being the beneficial owner of a significant or controlling interest or holding a management function in an insurer or an intermediary.

c. The supervisory authority has appropriate authority to co-operate effectively with the domestic Financial Intelligence Unit (FIU) and domestic enforcement authorities, as well as with other supervisors both domestic and foreign, for AML/CFT purposes.

d. The supervisory authority devotes adequate resources – financial, human and technical – to AML/CFT supervisory activities.

e. The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related

53 See FATF Recommendations 4-6, 8-11, 13-15, 17, 21-23, 25, 29-32 and 40 as well as Special Recommendations IV, V and the AML/CFT Methodology for a description of the complete set of AML/CFT measures that are required.

insurance, to comply with AML/CFT requirements, which are consistent with the FATF Recommendations applicable to the insurance sector, including:

- performing the necessary customer due diligence (CDD) on customers, beneficial owners and beneficiaries
- taking enhanced measures with respect to higher risk customers
- maintaining full business and transaction records, including CDD data, for at least 5 years
- monitoring for complex, unusual large transactions, or unusual patterns of transactions, that have no apparent or visible economic or lawful purpose
- reporting suspicious transactions to the FIU
- developing internal programmes (including training), procedures, controls and audit functions to combat money laundering and terrorist financing
- ensuring that their foreign branches and subsidiaries observe appropriate AML/CFT measures consistent with the home jurisdiction requirements.

Appendix C – Specific cases and examples of money laundering involving insurance

This appendix contains examples of money laundering or suspicious transactions involving insurance. It will be published on the IAIS website (www.iaisweb.org) as a separate document and updated whenever new examples involving insurance are reported.

Indicators

The following examples may be indicators of a suspicious transaction and give rise to a suspicious transaction report:

- application for a policy from a potential client in a distant place where a comparable policy could be provided "closer to home"
- application for business outside the policyholder's normal pattern of business
- introduction by an agent/intermediary in an unregulated or loosely regulated jurisdiction or where organised criminal activities (e.g. drug trafficking or terrorist activity) or corruption are prevalent
- any want of information or delay in the provision of information to enable verification to be completed
- an atypical incidence of pre-payment of insurance premiums
- the client accepts very unfavourable conditions unrelated to his or her health or age
- the transaction involves use and payment of a performance bond resulting in a cross-border payment (wire transfers) = the first (or single) premium is paid from a bank account outside the country
- large fund flows through non-resident accounts with brokerage firms
- insurance policies with premiums that exceed the client's apparent means
- the client requests an insurance product that has no discernible purpose and is reluctant to divulge the reason for the investment
- insurance policies with values that appear to be inconsistent with the client's insurance needs
- the client conducts a transaction that results in a conspicuous increase of investment contributions
- any transaction involving an undisclosed party
- early termination of a product, especially at a loss, or where cash was tendered and/or the refund cheque is to a third party
- a transfer of the benefit of a product to an apparently unrelated third party
- a change of the designated beneficiaries (especially if this can be achieved without knowledge or consent of the insurer and/or the right to payment could be transferred simply by signing an endorsement on the policy)
- substitution, during the life of an insurance contract, of the ultimate beneficiary with a person without any apparent connection with the policyholder
- requests for a large purchase of a lump sum contract where the policyholder has usually made small, regular payments
- attempts to use a third party cheque to make a proposed purchase of a policy
- the applicant for insurance business shows no concern for the performance of the policy but much interest in the early cancellation of the contract
- the applicant for insurance business attempts to use cash to complete a proposed transaction when this type of business transaction would normally be handled by cheques or other payment instruments

- the applicant for insurance business requests to make a lump sum payment by a wire transfer or with foreign currency
- the applicant for insurance business is reluctant to provide normal information when applying for a policy, providing minimal or fictitious information or, provides information that is difficult or expensive for the institution to verify
- the applicant for insurance business appears to have policies with several institutions
- the applicant for insurance business purchases policies in amounts considered beyond the customer's apparent means
- the applicant for insurance business establishes a large insurance policy and within a short time period cancels the policy, requests the return of the cash value payable to a third party
- the applicant for insurance business wants to borrow the maximum cash value of a single premium policy, soon after paying for the policy
- the applicant for insurance business use a mailing address outside the insurance supervisor's jurisdiction and where during the verification process it is discovered that the home telephone has been disconnected.

The above indicators are not exhaustive.

Life insurance

- A company director from Company W, Mr. H, set up a money laundering scheme involving two companies, each one established under two different legal systems. Both of the entities were to provide financial services and providing financial guarantees for which he would act as director. These companies wired the sum of USD 1.1 million to the accounts of Mr. H in Country S. It is likely that the funds originated in some sort of criminal activity and had already been introduced in some way into the financial system. Mr. H also received transfers from Country C. Funds were transferred from one account to another (several types of accounts were involved, including both current and savings accounts). Through one of these transfers, the funds were transferred to Country U from a current account in order to make payments on life insurance policies. The investment in these policies was the main mechanism in the scheme for laundering the funds. The premiums paid for the life insurance policies in Country U amounted to some USD 1.2 million and represented the last step in the laundering operation.[54]

- An attempt was made to purchase life policies for a number of foreign nationals. The underwriter was requested to provide life coverage with an indemnity value identical to the premium. There were also indications that in the event that the policies were to be cancelled, the return premiums were to be paid into a bank account in a different jurisdiction to the assured.

- On a smaller scale, local police authorities were investigating the placement of cash by a drug trafficker. The funds were deposited into several bank *accounts* and then transferred to an *account* in another jurisdiction. The drug trafficker then entered into a USD 75,000 life insurance policy. Payment for the policy was made by two separate wire transfers from the overseas *accounts*. It was purported that the funds used for payment were the proceeds of overseas investments. At the time of the drug trafficker's arrest, the insurer had received instructions for the early surrender of the policy.

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- In 1990, a British insurance sales agent was convicted of violating a money laundering statute. The insurance agent was involved in a money laundering scheme in which over USD 1.5 million was initially placed with a bank in England. The "layering process" involved the purchase of single premium insurance policies. The insurance agent became a top producer at his insurance company and later won a company award for his sales efforts. This particular case involved the efforts of more than just a sales agent. The insurance agent's supervisor was also charged with violating the money laundering statute.

  This case has shown how money laundering, coupled with a corrupt employee, can expose an insurance company to negative publicity and possible criminal liability.

- Customs officials in Country X initiated an investigation which identified a narcotics trafficking organisation utilised the insurance sector to launder proceeds. Investigative efforts by law enforcement agencies in several different countries identified narcotic traffickers were laundering funds through Insurance firm Z located in an off-shore jurisdiction.

  Insurance firm Z offers investment products similar to mutual funds. The rate of return is tied to the major world stock market indices so the insurance policies were able to perform as investments. The account holders would over-fund the policy, moving monies into and out of the fund for the cost of the penalty for early withdrawal. The funds would then emerge as a wire transfer or cheque from an insurance company and the funds were apparently clean. To date, this investigation has identified that over USD 29 million was laundered through this scheme, of which over USD 9 million dollars has been seized. Additionally, based on joint investigative efforts by Country Y (the source country of the narcotics) and Country Z customs officials, several search warrants and arrest warrants were executed relating to money laundering activities involved individuals associated with Insurance firm Z.[55]

- A customer contracted life insurance of a 10 year duration with a cash payment equivalent to around USD 400,000. Following payment, the customer refused to disclose the origin of the funds. The insurer reported the case. It appears that prosecution had been initiated in respect of the individual's fraudulent management activity.

- A life insurer learned from the media that a foreigner, with whom it had two life-insurance contracts, was involved in Mafia activities in his/her country. The contracts were of 33 years duration. One provided for a payment of close to the equivalent of USD 1 million in case of death. The other was a mixed insurance with value of over half this amount.

- A client domiciled in a country party to a treaty on the freedom of cross-border provision of insurance services, contracted with a life insurer for a foreign life insurance for 5 years with death cover for a down payment equivalent to around USD 7 million. The beneficiary was altered twice: 3 months after the establishment of the policy and 2 months before the expiry of the insurance. The insured remained the same. The insurer reported the case. The last beneficiary - an alias - turned out to be a PEP.

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Non-life insurance

- A money launderer purchased marine property and casualty insurance for a phantom ocean-going vessel. He paid large premiums on the policy and suborned the intermediaries so that regular claims were made and paid. However, he was very careful to ensure that the claims were less than the premium payments, so that the insurer enjoyed a reasonable profit on the policy. In this way, the money launderer was able to receive claims cheques which could be used to launder funds. The funds appeared to come from a reputable insurance company, and few questioned the source of the funds having seen the name of the company on the cheque or wire transfer. [56]

- Four broking agencies were forced to freeze funds after US court action that followed an investigation into Latin American drugs smuggling. The drug trafficking investigation, codenamed Golden Jet, was coordinated by the Drug Enforcement Agency (DEA) based in the USA but also involved the FBI and the UK authorities. The funds frozen by the court action related to insurance money deposited at insurance brokers for around 50 aircraft.

  It is understood that the brokers affected by the court order included some of the largest UK insurance brokers. The case highlighted the potential vulnerability of the insurance market to sophisticated and large scale drug trafficking and money laundering operators. The court order froze aircraft insurance premiums taken out by 17 Colombian and Panamanian air cargo companies and by 9 individuals. The action named 50 aircraft, including 13 Boeing 727s, 1 Boeing 707, 1 French Caravelle and 2 Hercules C130 transport aircraft. The British end of the action was just one small part of a massive anti-drug trafficking action co-ordinated by the DEA. Officials of the DEA believe Golden Jet is one of the biggest blows they have been able to strike against the narcotics trade. The American authorities led by the DEA swooped on an alleged Colombian drugs baron and tons of cocaine valued at many billions of dollars were seized and a massive cocaine processing factory located in Colombia together with aircraft valued at more than USD22 million were destroyed in the DEA coordinated action. According to the indictment, the cargo companies were responsible for shipping tons of cocaine from South to North America all through the 1980s and early 1990s, providing a link between the producers and the consumers of the drugs. Much of the cocaine flowing into the USA was transported into the country by air. During this period the Colombian cartels rose to wealth and prominence, aided by those transport links.

Intermediaries

- A person (later arrested for drug trafficking) made a financial investment (life insurance) of USD 250,000 by means of an insurance broker. He acted as follows. He contacted an insurance broker and delivered a total amount of USD 250,000 in three cash instalments. The insurance broker did not report the delivery of that amount and deposited the three instalments in the bank. These actions raise no suspicion at the bank, since the insurance broker is known to them as being connected to the insurance branch. The insurance broker delivers, afterwards, to the insurance company responsible for making the financial investment, three cheques from a bank account under his name, totalling USD 250,000, thus avoiding the raising suspicions with the insurance company.[57]

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- Clients in several countries used the services of an intermediary to purchase insurance policies. Identification was taken from the client by way of an ID card, but these details were unable to be clarified by the providing institution locally, which was reliant on the intermediary doing due diligence checks. The policy was put in place and the relevant payments were made by the intermediary to the local institution. Then, after a couple of months had elapsed, the institution would receive notification from the client stating that there was now a change in circumstances, and they would have to close the policy suffering the losses but coming away with a clean cheque from the institution. On other occasions the policy would be left to run for a couple of years before being closed with the request that the payment be made to a third party. This was often paid with the receiving institution, if local, not querying the payment as it had come from another reputable local institution.[58]

- An insurance company was established by a well-established insurance management operation. One of the clients, a Russian insurance company, had been introduced through the management of the company's London office via an intermediary. In this particular deal, the client would receive a "profit commission" if the claims for the period were less than the premiums received. Following an on-site inspection of the company by the insurance regulators, it became apparent that the payment route out for the profit commission did not match the flow of funds into the insurance company's account. Also, the regulators were unable to ascertain the origin and route of the funds as the intermediary involved refused to supply this information. Following further investigation, it was noted that there were several companies involved in the payment of funds and it was difficult to ascertain how these companies were connected with the original insured, the Russian insurance company.

- A construction project was being financed in Europe. The financing also provided for a consulting company's fees. To secure the payment of the fees, an investment account was established and a sum equivalent to around USD 400,000 deposited with a life-insurer. The consulting company obtained powers of attorney for the account. Immediately following the setting up of the account, the consulting company withdrew the entire fee stipulated by the consulting contract. The insurer reported the transaction as suspicious. It turns out that an employee of the consulting company was involved in several similar cases. The account is frozen.

Reinsurance

- An insurer in country A sought reinsurance with a reputable reinsurance company in country B for its directors and officer cover of an investment firm in country A. The insurer was prepared to pay four times the market rate for this reinsurance cover. This raised the suspicion of the reinsurer which contacted law enforcement agencies. Investigation made clear that the investment firm was bogus and controlled by criminals with a drug background. The insurer had ownership links with the investment firm. The impression is that - although drug money would be laundered by a payment received from the reinsurer – the main purpose was to create the appearance of legitimacy by using the name of a reputable reinsurer. By offering to pay above market rate the insurer probably intended to assure continuation of the reinsurance arrangement.

- A state insurer in country A sought reinsurance cover for its cover of an airline company. When checking publicly available information on the company it turned out that the

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company was linked to potential war lords and drug traffickers. A report was made to the law enforcement authorities.

Return premiums

There are several cases where the early cancellation of policies with return of premium has been used to launder money. This has occurred where there have been:

- a number of policies entered into by the same insurer/intermediary for small amounts and then cancelled at the same time
- return premium being credited to an account different from the original account
- requests for return premiums in currencies different to the original premium, and
- regular purchase and cancellation of policies.

Over payment of premiums

Another simple method by which funds can be laundered is by arranging for excessive numbers or excessively high values of insurance reimbursements by cheque or wire transfer to be made. A money launderer may well own legitimate assets or businesses as well as an illegal enterprise. In this method, the launderer may arrange for insurance of the legitimate assets and 'accidentally', but on a recurring basis, significantly overpay his premiums and request a refund for the excess. Often, the person does so in the belief that his relationship with his representative at the company is such that the representative will be unwilling to confront a customer who is both profitable to the company and important to his own success.

The overpayment of premiums, has, been used as a method of money laundering. Insurers should be especially vigilant where:

- the overpayment is over a certain size (say USD10,000 or equivalent)
- the request to refund the excess premium was to a third party
- the assured is in a jurisdiction associated with money laundering and
- where the size or regularity of overpayments is suspicious.

High brokerage/third party payments/strange premium routes

High brokerage can be used to pay off third parties unrelated to the insurance contract. This often coincides with example of unusual premium routes.

Claims

A claim is one of the principal methods of laundering money through insurance. Outlined below are examples of where claims have resulted in reports of suspected money laundering and terrorist financing.

- A claim was notified by the assured, a solicitor, who was being sued by one of his clients. The solicitor was being sued for breach of confidentiality, which led to the client's creditors discovering funds that had allegedly been smuggled overseas. Documents indicated that the solicitor's client might be involved in tax evasion, currency smuggling and money laundering.

- A claim was notified relating to the loss of high value goods whilst in transit. The assured admitted to investigators that he was fronting for individuals who wanted to invest “dirt money” for a profit. It is believed that either the goods, which were allegedly purchased with cash, did not exist, or that the removal of the goods was organised by the purchasers to ensure a claim occurred and that they received “clean” money as a claims settlement.

- Insurers have discovered instances where premiums have been paid in one currency and requests for claims to be paid in another as a method of laundering money.

- During an on-site visit, an insurance supervisor was referred to a professional indemnity claim that the insurer did not believe was connected with money laundering. The insurer was considering whether to decline the claim on the basis that it had failed to comply with various conditions under the cover. The insurance supervisor reviewed the insurer’s papers, which identified one of the bank’s clients as being linked to a major fraud and money laundering investigation being carried out by international law enforcement agencies.

- After a successful High Court action for fraud, adjusters and lawyers working for an insurer involved in the litigation became aware that the guilty fraudster was linked to other potential crimes, including money laundering.

Assignment of claims

In a similar way, a money launderer may arrange with groups of otherwise legitimate people, perhaps owners of businesses, to assign any legitimate claims on their policies to be paid to the money launderer. The launderer promises to pay these businesses, perhaps in cash, money orders or travellers cheques, a percentage of any claim payments paid to him above and beyond the face value of the claim payments. In this case the money laundering strategy involves no traditional fraud against the insurer. Rather, the launderer has an interest in obtaining funds with a direct source from an insurance company, and is willing to pay others for this privilege. The launderer may even be strict in insisting that the person does not receive any fraudulent claims payments, because the person does not want to invite unwanted attention.

Non-life insurance – fraudulent claims

- Police in Country A uncovered a case of stolen car trafficking where the perpetrators provoked accidents in Country B to be able to claim the damages. The proceeds were laundered via public works companies. A network consisting of two teams operated in two different regions of Country A. Luxury vehicles were stolen and given false number plates before being taken to Country B. An insurance contract was taken out in the first country on these vehicles. In Country B, the vehicles were deliberately written off and junk vehicles with false number plates were bought using false identity documents to be able to claim the damages from the insurance firms in Country A. Around a hundred luxury stolen vehicles were used in this scheme to claim the damages resulting from the simulated or intentional accidents that were then fraudulently declared to the insurance firms. The total loss was over USD 2.5 million. The country in which the accidents occurred was chosen because its national legislation provided for prompt payment of

damages.

On receipt of the damages, the false claimants gave 50% of the sum in cash to the leader of the gang who invested these sums in Country B. The investigations uncovered bank transfers amounting to over USD 12,500 per month from the leader's accounts to the country in question. The money was invested in the purchase of numerous public works vehicles and in setting up companies in this sector in Country B. Investigations also revealed that the leader of the gang had a warehouse in which luxury vehicles used for his trafficking operation were stored. It was also established that there was a business relationship between the leader and a local property developer, suggesting that the network sought to place part of its gains into real estate.[59]

- An individual purchases an expensive new car. The individual obtains a loan to pay for the vehicle. At the time of purchase, the buyer also enters into a medical insurance policy that will cover the loan payments if he were to suffer a medical disability that would prevent repayment. A month or two later, the individual is purportedly involved in an "accident" with the vehicle, and an injury (as included in the insurance policy) is reported. A doctor, working in collusion with the individual, confirms injury. The insurance company then honours the claim on the policy by paying off the loan on the vehicle. Thereafter, the organisation running the operation sells the motor vehicle and pockets the profit from its sale. In one instance, an insurance company suffered losses in excess of $2 million from similar fraud schemes carried out by terrorist groups.

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Appendix D – List of abbreviations

AML	Anti-money laundering
CDD	Customer due diligence
CFT	Combating the financing of terrorism
FATF	Financial Action Task Force on Money Laundering
FIU	Financial intelligence unit
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
NCCTs	Non-cooperative countries and territories
PEP	Politically exposed person
STR	Suspicious transaction report

Guidance Paper No. 6

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SOLVENCY CONTROL LEVELS GUIDANCE PAPER

October 2003

[This document was prepared by the Solvency Subcommittee in consultation with members and observers.]

Solvency control levels guidance paper

Contents

1. Introduction

1. The IAIS adopted a paper in January 2002 entitled *Principles on capital adequacy and solvency* that sets out principles that generally underlie solvency regimes for insurers. That paper sets out three principles regarding the level of solvency*: Principle 6 – Capital adequacy and solvency regimes have to be sensitive to risk, Principle 7 – A control level is required* and *Principle 8 – A minimum level of capital has to be specified.* This guidance paper addresses Principle 7, as a component of a solvency regime that it is assumed satisfies Principles 6 and 8. Guidance with respect to Principles 6 and 8 will be the subject of future papers.

2. The purpose of this guidance paper is to discuss why it is important to set a solvency control level, to identify key factors in setting a solvency control level, and to discuss possible supervisory actions when a solvency control level is breached. The form of the solvency control level varies between jurisdictions and may be based on capital levels or other financial measures related to the solvency regime of the jurisdiction (e.g., accounting practices and level of coverage of technical provisions by admissible assets). A survey of practices in IAIS Solvency Subcommittee member jurisdictions was conducted and the responses have informed the development of this guidance paper.

3. The paper discusses possible courses of supervisory action when a solvency control level is breached. It should be emphasised that there are many other reasons relating to the activities and/or financial position of an insurer that may warrant supervisory intervention. The ability to intervene in respect to a variety of concerns is an essential element of a supervisory system. The scope of this paper is not intended to address the full range of possible reasons for intervention.

4. It is important to note why solvency requirements are essential in the supervision of insurers and the protection of policyholders. An insurer's technical provisions should be sufficient to cover all expected claims and some unexpected losses, as prescribed by the applicable valuation requirements. The degree to which technical provisions will cover unexpected losses will vary by jurisdiction depending upon the local regulatory structure and philosophy. There should be sufficient capital to absorb unexpected losses to the extent not covered by the technical provisions on the risks specifically contemplated by the capital establishment process. Further, additional capital is required to absorb losses from risks not identified by the capital establishment process, including operational risk, and to provide for losses due to the business environment, including economic and systemic risk**.** In order to protect policyholders from undue loss, it is necessary to establish not only a minimum capital level,

but also a solvency control level, or series of control levels, which act as indicators or triggers for early supervisory action, before problems become serious threats to the insurer's solvency.

5. In addition to formal solvency control levels, some jurisdictions also have informal solvency control levels, which are used to determine the extent of supervisory activity related to insurers.

2. Solvency control level

6. As outlined in the IAIS *Principles on Capital Adequacy and Solvency* paper, "insurance regulatory authorities have to establish a control level, or a series of control levels, that trigger intervention by the authority in an insurer's affairs when the available solvency falls below this control level. The control level may be supported by a specific framework or by a more general framework providing the supervisor a latitude of action."

7. A supervisor's goal in establishing control levels is to safeguard policyholders from excessive loss due to an insurer's inability to meet its obligations. In some jurisdictions, the supervisor's mandate extends to contributing to public confidence in the financial system. Insurers should operate above the minimum requirements to cope with volatility in markets and economic conditions, innovations in the industry and international developments.

8. Various global market events have highlighted the need for insurers to maintain strong solvency positions. These events put stress on the insurance industry that cannot be reliably quantified. Each insurer should maintain a financial position that provides a cushion of solvency above minimum requirements to enable it to cope with volatility in markets and economic conditions, innovations in the industry and other developments. An insurer should be able to weather such stresses without triggering supervisory consequences, and to address its capital needs through ongoing market access.

9. The control level should be set high enough to allow intervention at a sufficiently early stage in an insurer's difficulties so that there would be a realistic prospect for the situation to be rectified. At the same time, the reasonableness of the control levels should be examined in relationship to the nature of the corrective measures. Early corrective measures may be kept confidential in order to not risk an insurer's reputation and thus worsen the situation.

10. An insurer may continue to take on new risks, on a going concern basis, during a period of stress. Therefore, the control level must be set high enough to provide an acceptable level of solvency, when considering the potential growth in an insurer's portfolio, throughout the period that may be required for the resolution of problems or the recovery from unusual or catastrophic events.

11. When establishing solvency control levels, it is recognised that views about which level is acceptable may differ from jurisdiction to jurisdiction. The control level should be high enough to ensure that if an insurer's failure is inevitable, it can be managed with minimum loss to policyholders. Where permitted by the supervisory framework, it is also useful for a supervisor to have flexibility on a case-by-case basis to vary the solvency control level for an individual insurer, based upon its risk profile. Some insurers may warrant a higher control level if they are undertaking higher risks, such as new products where creditable experience is not available to establish technical provisions, or if they are undertaking significant risks that are not specifically covered by the solvency test. Particularly in cases where legal action may be taken in response to an insurer violating its control level, the criteria used by the supervisor to establish solvency control levels should be transparent. Section III of this paper discusses a number of factors that should be taken into consideration when establishing a solvency control level.

12. While it is important that a supervisor have the authority to establish a solvency control level, insurers should also be encouraged to operate with higher solvency margins to support the risks that they undertake, both on and off the balance sheet. Insurers should be encouraged to develop and review, from time-to-time, their own internal target solvency levels to ensure that such targets prudently reflect their risk profile. While senior management may develop target levels, to encourage accountability the targets should be reviewed and approved by the insurer's Board of Directors.

3. Considerations in setting a solvency control level

13. There are a number of general issues that supervisors should take into consideration when setting a solvency control level**.** They include, but are not limited to:

Risk coverage issues

- quality of capital – supervisors should consider the quality of capital available, to ensure that there are adequate levels of permanent capital available to absorb losses during ongoing operations. For example, it may be necessary to establish control capital levels not only for total capital but also for the level of permanent capital (e.g., retained earnings and equity instruments which can absorb losses during ongoing operations, versus debt instruments which are not permanent). A strong level of permanent capital allows an insurer to conserve resources when it is under stress, since it provides the insurer with discretion as to the amount and timing of distributions

- sensitivity of solvency requirements to risks – the solvency control level may be based upon a going concern assessment of the financial position of the insurer that recognises the dynamic pressures and possible changes in economic and market conditions. Stress tests[1] of the financial condition of the insurer against these more dynamic assumptions and scenarios are a useful supervisory tool, that can assist the supervisor in assessing whether an individual insurer's risk profile warrants a solvency control level that differs from the industry-wide norm

- the minimum solvency level – the amount of the minimum level determines the cushion that it provides to absorb losses. There may or may not be a direct relationship between the solvency control level and the minimum level. In some jurisdictions, the solvency control level is a function of the minimum capital level (e.g., in Canada, the solvency control level for life insurers is 125% of the minimum capital level)

- risks not covered by the solvency rules – the extent to which there are risks not covered in the calculation of the solvency requirements will influence both the minimum level and the control level. Examples of significant risks that are often not explicitly captured by capital adequacy rules are operational risk and liquidity risk

[1] In Canada, the appointed actuary is required to dynamically test the insurer's capital adequacy on an annual basis and report on the future financial condition to the Board of Directors in the Dynamic Capital Adequacy Testing (DCAT) Report. The Canadian Institute of Actuaries has issued a Standard of Practice on DCAT that provides guidance to the actuary. The process involves analysing and projecting the trends of an insurer's capital position to understand the risk profile of the insurer and potential threats to its capital adequacy given current circumstances, its recent past and its intended business plan under a variety of plausible future adverse scenarios. The purpose is to identify: plausible threats to satisfactory financial condition, actions that lessen the likelihood of those threats, and actions that would mitigate a threat if it materialised. The principle goal is to help prevent insolvency by arming the insurer with the best information on the course of events that may lead to capital depletion, and the relative effectiveness of alternative corrective actions.

- mix of business and investments which results in a higher level of risk than the average level that is implicit in the standard solvency requirement

- the level of security in a broad sense – the amount of risk coverage provided by the technical provisions and requirements regarding investments, as protection of policyholders from undue loss.

Supervisory and jurisdictional issues

- the powers of the supervisor, which are derived from the legislative framework within a jurisdiction, will be a key determinant of the ability of the supervisor to establish and adjust minimum and control levels of solvency, both on an industry-wide and insurer-specific basis. In some jurisdictions the minimum and control levels are established by legislation, whereas in other jurisdictions the supervisor has the authority to impose alternative solvency requirements

- need for flexibility – an insurer's individual risk profile should be assessed to determine whether the industry solvency control level should be applied or a higher level applied, e.g., there may be non-capital-related supervisory concerns within an insurer that may cause the supervisor to require that a higher solvency level be maintained until a problem is rectified

- prudence of the accounting and actuarial standards – the level of conservatism in the requirements for valuation of the assets and liabilities and the accounting practices within the jurisdiction should be evaluated to determine the additional margins required to protect policyholders

- licensing requirements – a minimum amount of capital is required to be licensed to write business in a jurisdiction. However, a separate control level may be established for new insurers to provide for growth of new business or other risks related to their operating plans

- legal status of policyholders – the legislative protection provided to policyholders relative to other creditors is an important factor in setting both minimum and control levels of solvency

- extent to which the preconditions for effective supervision, as set out in the IAIS Insurance Core Principles, exist.

Other issues

- overall level of capitalisation in the industry – a transition period may be required to achieve the desired level of capital for the industry within a jurisdiction

- developments within the industry – e.g., new products, globalisation, increased competition

- competitiveness – the solvency control level must not unduly impede the ability of the insurance industry to compete in the global marketplace. This is a balance between the protection of policyholders and the need for insurers to earn a return on equity which is competitive with other financial services sectors and other enterprises generally

- economic environment in the jurisdiction – e.g., level of inflation and interest rates

- development of capital markets in the jurisdiction – e.g., affects the insurer's ability to raise capital

- risk management in the jurisdiction – e.g., the sophistication of the risk management systems prevalent in the insurance industry

- policyholder protection/guarantee fund – existence of a fund should not be considered in setting the solvency control levels. To do so would raise issues such as potential moral hazard, competitive equity, and geographic, product or amount limitations on protection.

14. If supervisors establish unique solvency control levels for individual insurers, they should also consider the following insurer-specific issues in addition to those discussed above:

- quality of management, risk management systems and internal controls within the insurer. Where the capabilities of management or the quality of a risk management framework within an insurer are weak, the supervisor should consider prescribing a higher level of solvency

- ratings requirements – capital levels required to maintain adequate ratings by external rating agencies. Insurers may have ratings they need to maintain in order to participate in certain markets (e.g., reinsurance) or to access capital on acceptable terms

- insurers' own internal target levels – insurers' own risk modelling and assessment, and their own evaluation of the economic capital required to cover the risks of their business, to the extent considered credible.

4. Possible supervisory actions

15. Supervisory regimes typically provide a variety of powers that may be invoked by supervisors and refer to measures they may take to address various practices and situations that are of concern. It is common for supervisors to identify possible supervisory actions that could be taken in the event an insurer breaches the solvency control level or is trending towards a breach. These actions may or may not be strictly tied to the solvency control level and may or may not be formalised in legislation or regulatory documents. It is important that the supervisor have adequate authority to take action to attempt to ensure that solvency control levels are maintained, in order to provide adequate protection to policyholders.

16. It is also important that insurers be aware of the range of possible supervisory actions that could be taken if they breach the solvency control level. Awareness within the industry of the possible consequences may act as a disciplinary force to encourage the maintenance of the solvency control levels. In most jurisdictions surveyed, the severity of the supervisory intervention increases as an insurer's solvency position falls below the solvency control level towards the minimum solvency level.

17. Supervisory actions should be directed towards strengthening the insurer's solvency position and maintaining or returning it to a level above the solvency control level.

18. Possible supervisory actions, which may be taken separately or jointly, may be categorised as follows:

- measures that directly address the problem of not enough capital, e.g., requesting capital and business plans for restoration of solvency levels, vested asset injections, limiting redemption/repurchase of equity instruments, limitations on dividend payments

- measures that are punitive, e.g., refusing, delaying or imposing conditions on requests or applications submitted for regulatory approval, such as innovative capital instruments, acquisitions and redemptions or repurchases of equity, limiting growth in business

- measures that are intended to protect policyholders pending strengthening of the solvency position, e.g., business restrictions on licences, premium volume limitations, restrictions on certain types of business or investments, limitations on shareholder dividends, restrictions on acquisitions, business dispositions and reinsurance arrangements

- measures that are intended to enable the supervisor to better assess and control the situation, whether by formal or informal means, e.g., increased supervision activities and guidance, requiring auditors to enlarge or extend the scope of their examinations, requiring additional stress testing and scenario analysis, requiring actuaries to modify actuarial assumptions as appropriate to the circumstances, commissioning independent actuarial reviews, and applying prudential limits and restrictions more rigorously

- measures that strengthen or replace an insurer's management.

19. In the event that measures taken to improve the solvency position of an insurer are not successful and its solvency level continues to deteriorate, the severity of supervisory actions should progressively increase. These actions may include invoking statutory powers to rectify the situation, e.g., issuing a directive to increase capital and/or liquidity, a divestment order, a direction of compliance, removal of management and taking control of assets or the insurer.

20. Conversely, the supervisory regime may provide for benefits to insurers that are operating well above the solvency control levels. This may include streamlining specified regulatory approvals, reducing reporting requirements and increasing investment flexibility. These actions may be viewed by the industry as inducements to maintain stronger solvency positions.

5. Disclosure of solvency control level

21. In many jurisdictions, the possible supervisory consequences of falling below the minimum and solvency control levels are transparent to the public in either legislation or other forms of regulatory guidance.

22. The *Principles on capital adequacy and solvency* paper states, "The capital adequacy and solvency regime should be supported by appropriate disclosure." In general, public disclosure of information regarding an insurer's solvency position enhances policyholders' and the market participants' ability to exercise discipline with respect to insurers. Market discipline is enhanced by transparency of the solvency control level requirements and imposes strong incentives on insurers to conduct their business in a safe, sound and efficient manner. However, the sensitivity of the market to publicity regarding an insurer's solvency position should be considered when establishing disclosure requirements. While not all jurisdictions require information about individual insurers' solvency positions to be made available to the public, this can be a powerful supervisory tool which should be considered. It should be noted that while the disclosures provide an indication of the solvency position of the insurer, they are not the only indicator of the financial condition of an insurer and should not be used in isolation.

23. Once a solvency control level and its meaning are well known, there may be convergence towards that level or a higher level, as disclosure of individual insurer solvency levels can provide an incentive to maintain a strong solvency position as a cushion against potential future losses arising

from its risk exposures. Market discipline reinforces supervisory efforts to promote safety and soundness in insurers and will encourage insurers to ensure that their solvency positions do not fall significantly below those of their peers.

Guidance Paper No. 7

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

THE USE OF ACTUARIES AS PART OF A SUPERVISORY MODEL GUIDANCE PAPER

October 2003

[This document was prepared by the Solvency Subcommittee in consultation with members and observers.]

The Use of actuaries as part of a supervisory model guidance paper

Contents

1. Introduction

1. This paper considers the use of an actuary as part of an insurance supervisory model. In some jurisdictions where use is made of an actuary in the supervisory model, this use is referred to as an 'appointed actuary' or a 'responsible actuary' system. While this system may have variations, it is essentially based upon the mandated use of an actuary by insurers, with that actuary having specified reporting or certification responsibilities to both the insurer and the supervisor.

2. It is noted that, even where there may not be a specified role in the insurance laws or regulations, supervisors look to actuaries within insurers as important contributors to the supervisory process. The paper draws some generally applicable conclusions, but when considering the specific role of an actuary, which may be set out in regulations, the term 'responsible actuary' is used.

3. Regardless of the roles actuaries may play within the supervisory model of a particular jurisdiction, nothing in this paper should be taken to suggest any reduction in the responsibilities that appropriately fall on an insurer's management, directors or external auditors.

4. This paper has two main objectives.

- First, the paper represents the results of a survey of current practice and the discussions of the IAIS Subcommittee on Solvency, Solvency Assessments and Actuarial Issues (Solvency Subcommittee).

- Second, for those jurisdictions that are considering the introduction, expansion or reform of a responsible actuary system, the paper may be of assistance in identifying issues to be considered as the system is developed and implemented.

The paper draws a number of conclusions, which are set out throughout the text.

2. Methodology

5. The paper has been developed as a guidance paper. In preparing the paper, a survey of several jurisdictions represented on the Solvency Subcommittee was conducted. Where comments are made in this paper based on the survey, reference is made to 'responding jurisdictions'. The paper was then circulated as a draft for comments to the various committees and the membership of the IAIS and these comments were considered as the paper was finalised.

6. In addition, useful current papers were provided by members of the Solvency Subcommittee reflecting the recent work in this area done by the EU and the OECD. A table of references is also provided at the end of this paper.

3. The role of actuaries in insurance

7. The *Issues paper* prepared by the Solvency Subcommittee includes a discussion of insurance risks and risk assessment for insurers and the role of actuaries in these areas. That paper, released in March 2000, noted that different regulatory traditions ascribe different levels of professional responsibility to the actuary. In particular, the *Issues paper* stated that:

- "Regardless of regulatory traditions, the role of the actuary, both within the insurance companies and in the position of supervisor, is critical to the maintenance of financially sound insurance companies. Dependant on traditions within the different jurisdictions, however, the term 'actuary' in this context does not necessarily relate to membership in certain professional associations, or to certain university degrees. What is essential, is to ensure that the insurance undertakings possess the competence and qualifications required for risk identification and control. Mathematicians and economists with insight in and experience from the insurance business may play this part as well as "actuaries" in the narrow sense of the word".

8. It is common for actuaries to have some level of involvement in insurance. There is a longer tradition of this in life insurance than in non-life insurance. There is, of course, variation in where these actuarial skills are drawn from. For instance, some insurers have actuaries as employees, while others employ consultants. Actuarial expertise is also not limited to the insurers and to the auditing and consulting firms alone. Typically, supervisory authorities also have actuarial staff, the number of which may vary depending upon the availability of qualified and experienced actuaries, costs and the supervisory model. Some choose to hire staff with a mathematical background and help them to train as actuaries, while others prefer to use consulting actuaries.

Conclusion #1:

The application of actuarial expertise is a key component in the operation of insurers, insurance markets and insurance supervisory authorities.

The definition of 'actuary'

9. In this paper we have adopted the definition of actuary as set out in the *IAIS Glossary*. The glossary states:

- "An actuary is a professional trained in evaluating the financial implications of contingent events. Actuaries require an understanding of the stochastic nature of insurance, the risks inherent in assets and the use of statistical models. These skills are often, for example,

used in establishing premiums and technical provisions for insurance products, using the combination of discounted cash flows and probabilities."

10. Actuarial skills are used to assess risk, determine the adequacy of premiums (tariffs) and establish technical provisions for both life and non-life insurance. These skills include a detailed understanding of the probabilities of insurance risks, (e.g., mortality, morbidity, claim frequencies and severities), the use of statistical models, the use of discounted cash flows, understanding and assessment of the use of derivatives and an understanding of volatility and adverse deviation. After appropriately applying these skills, actuaries provide advice and, where members of management, participate in decision-making.

The relationship between external auditors and actuaries

11. While the focus of this paper is on the role and use of actuaries, it is important to note the role of external auditors in the supervisory model.

12. The financial statements of an insurer, which may include amounts determined by an actuary, are the responsibility of management. The primary role of an external auditor is to express an opinion as to whether the financial statements have been prepared in accordance with the identified financial reporting framework. This opinion helps to establish the credibility of the financial statements and may be relied upon not only by supervisors, but also by shareholders, policyholders, rating agencies and tax authorities. The involvement of an actuary in the preparation of an insurer's financial statements, whether under a responsible actuary model or otherwise, should not lessen either the responsibility of management to produce reliable financial statements or the responsibility of the external auditor to express an opinion on such financial statements.

13. In auditing the financial statements of an insurer, the external auditor must address the technical provisions established by the insurer. It is important to have reliable data as the basis for calculating technical provisions. The external auditor plays an important role in ensuring the reliability of the data. The calculation of these provisions generally requires special expertise, methods and techniques, which are provided by an actuary. In some cases, actuaries are employed within auditing firms. The external auditor, if not possessing this expertise, may engage an actuary to review the methods, techniques and calculations underlying the insurer's provisions; in some jurisdictions such a review is required. This independent actuarial advice enables the auditor to reach an informed conclusion regarding the appropriateness of the insurer's provisions. While external auditors and actuaries may be subject to different legal frameworks across jurisdictions, the work of an external auditor and an actuary are closely linked.

14. In particular, the relationship between actuaries and external auditors is enhanced by:

- clear definition of roles of the actuary and the external auditor
- arrangements for formal communication between the actuary and the external auditor.

The relationship between the actuary and the external auditor might be set out in law, regulations or professional guidance. For example, in Canada, there is an agreement between the actuarial profession and the accounting profession that there be annual formal letters between the actuary and the external auditor specifying the work for which each is responsible.

Conclusion #2:

The roles of actuaries and external auditors, and relationships between them, are enhanced by a clear definition of their respective responsibilities.

4. Issues to be considered regarding adoption of a responsible actuary model

15. This section considers issues that are relevant in considering whether it is appropriate and feasible to adopt a responsible actuary model in a particular jurisdiction. Here we are considering the responsible actuary as someone with individual official responsibilities, or a defined role set out in the insurance regulation. The responsible actuary model is not the only model available to address actuarial matters as part of the supervision process. There are other models without the legislative requirement for a responsible actuary, where there is a different distribution of responsibilities and a greater emphasis on actuarial skills within the supervisory authority.

16. A key issue in considering the adoption of a responsible actuary model is the supervisory philosophy. The organisation of the supervisor also influences the role of actuaries in insurance supervision. Other issues, such as the state of the insurance market in a particular jurisdiction and the development of the actuarial profession in the jurisdiction, may also influence whether the responsible actuary model is adopted.

Philosophical position

17. At one end of the regulatory spectrum are those supervisory models that utilise a responsible actuary model. The Canadian approach is one such example.

18. The approach in Canada involves a continuously appointed, individually named person who, under the relevant legislation, is required to carry out an annual valuation of the liabilities of the insurance business. The responsible actuary must annually calculate the technical provisions and certify that they are calculated in accordance with actuarial practice generally accepted in Canada, including the use of appropriate assumptions and methods, that they make appropriate provision for all policyholder obligations and that the consolidated financial statements fairly present the results of the valuation. The responsible actuary must also provide an annual certificate, which details the amount of the required minimum solvency margin. The responsible actuary is also required to perform annual stress testing of the insurer's future financial condition.

19. Under the Canadian approach, the responsible actuary is clearly expected to act as a front-line controller of prudential financial management. The link to the insurance supervisor is through the legislative duty to 'whistle-blow', to the Board and the insurance supervisor, if the management of the insurer insists on pursuing a strategy which the responsible actuary believes may have a serious adverse impact on the insurer.

20. Under the Canadian system, the responsibilities of the actuary are spelled out in legislation and direct requirements of the insurance supervisory authority. A detailed body of professional guidance issued and enforced by the local professional body supports these requirements. Deregulated insurance markets place additional demands on the actuarial profession, leading to effective solutions along the lines of the responsible actuary system and its variants. It seems likely that solutions of this general type will become increasingly widespread throughout the world, necessitating high levels of actuarial education and professionalism, and requiring the active support and involvement of

professional associations of actuaries in each country. The role of the actuary in Canada has progressed steadily away from the historic evaluation of the liabilities, to also monitoring the adequacy of assets to meet the liabilities on a continuous basis. This expanded role includes providing a forward-looking report to the Boards of Directors on stress and scenario testing of a firm's current and future financial condition and playing a key role in the identification of risk and its successful management. The responsible actuary acts as an additional front-line control, which makes it possible to reduce the degree of direct supervisory oversight, replacing it with a degree of oversight of the fitness and propriety of the actuary and the effectiveness of the functioning of the actuary in the required role.

21. Alternatively, at the other end of the spectrum are those systems that do not mandate the use of an actuary. As indicated above, not all jurisdictions make use of an actuary as an explicit part of the supervisory model. Notable jurisdictions in this group are France and Spain. While most EU countries have adopted some form of a responsible actuary model, some have a different actuarial tradition. In particular, the French and Spanish approaches emphasise the importance of direct supervisory overview.[1]

22. A number of reasons are put forward in favour of not adopting a responsible actuary system. It is important to recognise the validity of these reasons because they clearly illustrate the consequences that would follow for the supervisory system as a result of a decision to adopt or not to adopt such a system.

23. For example, in France, the actuary of the insurer may approve the mortality tables used, but plays an otherwise relatively limited official supervisory role. Responsibility for the proper pricing of products, establishing prudent technical provisions and exercising sound and prudential overall financial management rests with the insurer's chief executive and the Board of Directors. The French supervisory approach strongly supports the use of actuarial skills by insurers in carrying out this responsibility, and allows the insurer the choice of using internal staff or outsourcing this function.

24. Under the French approach, the supervisor looks to the actuary within the insurer as a particular point of reference for supervisory questions and for the resolution of issues that it wishes to raise with the insurer.

25. The French supervisory approach considers the use of a responsible actuary system as lessening the powers of supervisors and restricting the relationship between the supervisor and the insurers. Direct supervision is exercised through a strong level of on-site inspection carried out by technically skilled supervisors, with accounting and actuarial skills, who not only review the financial statements, but also pay extended visits to the insurers to review their systems and controls, approve their technical bases and methodologies and audit a sample of their calculations.

26. There is a range of ways in which the responsible actuary system can be implemented. Many jurisdictions with a responsible actuary system also make extensive use of on-site inspections in the same manner as those jurisdictions that do not have a responsible actuary system.

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[1] France refers to this approach as "the two-actuary model". However, it should be noted that the responsible actuary model also makes use of actuaries in both the insurer and the supervisory authority.

Conclusion #3:

The decision on the use of a responsible actuary in an official capacity as part of a supervisory model should give due regard to the need to ensure effective supervisory oversight and management accountability.

27. Even after making a decision in favour of a responsible actuary model, it is then necessary to consider just what role and tasks are to be covered.

Conclusion #4:

Where a responsible actuary model is adopted, the actuary should have clearly-defined tasks and responsibilities, as well as rights and obligations under the law. These tasks and responsibilities can change over time.

Conclusion #5:

In the event that the use of a responsible actuary in the supervisory model is not adopted, then the supervisor has to have access to sufficient actuarial resources to perform detailed and quantitative reviews, as required.

The nature of the insurance market in the jurisdiction

28. A second, more practical, issue is the nature of the insurance market in the jurisdiction.

29. In some markets, there are a great number of insurers, while others have only a small number of insurers. The larger the number of insurers, the greater the tendency for the supervisor to make more formal use of actuaries, as this can assist the supervisor to more effectively allocate resources. However, even if the number of insurers is small, should the insurers be large and have complex operations, the supervisor would have more need for the assistance of actuaries than if the insurers were small and had simple operations.

30. The number of insurers and the nature of their operations may mean that there are practical issues to be overcome should a responsible actuary system be adopted. In some jurisdictions, a larger number of insurers may make it difficult to initially find sufficient adequately qualified and experienced actuaries to carry out the role.

The desire of the supervisor to encourage change

31. A third issue, which is also practical in nature, is the desire of the insurance supervisor to encourage the greater use of actuaries. The Solvency Subcommittee believes that the use of actuarial skills and advice can enhance the assessment of risk in an insurer, irrespective of the supervisory model used.

32. The supervisor may introduce an official role for an actuary in order to encourage insurers to make greater use of actuarial techniques. The supervisor can do so, and enhance the role of actuaries, by requiring reports to be signed or co-signed by an actuary, and by encouraging the involvement of the actuary in meetings and dialogues between supervisors and insurers.

The development of the actuarial profession in the jurisdiction

33. Another key issue in the decision to adopt the use of a responsible actuary model is the state of the actuarial profession, relative to the industry, in the particular jurisdiction.

34. A practical issue is the availability of suitably qualified and experienced actuaries in the jurisdiction. In some jurisdictions, the number of actuaries available to carry out an official role is limited. This could lead to immediate practical constraints on any proposal to implement a responsible actuary system. One way to address such a situation may be to allow actuaries from other jurisdictions to carry out an official role, provided that the actuaries have suitable qualifications and experience relating to the jurisdiction. In such a situation, the actuaries should be available to participate in discussions with the supervisor and to be consulted effectively.

35. Several responding jurisdictions place considerable reliance on the fact that the market has operated with actuarial advice for some time and that the profession is well organised. This issue is considered in more detail below.

36. The use of methods to enhance the quality of work of responsible actuaries, such as: practising certificates, peer reviews, disciplinary procedures, continuing professional development and others, may be required by the professional actuarial association or by the supervisory authority.

37. The decision to implement a responsible actuary system can, of itself, have an effect on the availability of actuaries in the jurisdiction. The reinforcement of the role of the actuary through the assumption of higher responsibilities could make the profession more attractive to those who may consider joining the actuarial profession in the jurisdiction, which could itself be an objective.

Conclusion #6:

The decision to adopt an official role for actuaries should take account of the availability of suitably qualified actuaries and the extent to which the profession is well organised.

Actuarial advice does not eliminate the need for supervisory oversight

38. A risk in adopting a responsible actuary model is the potential for the supervisor to simply accept the advice of the actuary without undertaking any independent assessment of the actuary's work. The supervisor should still have access to actuarial resources, or other resources, that are able to critically assess the work of the responsible actuary, including the assumptions and methods used and conclusions reached, and should not simply accept the actuary's advice without scrutiny.

39. This requirement for scrutiny may be influenced by the level of actuarial expertise available within the supervisory authority. For instance, the EU Insurance Committee has found that while the supervisors of some member states employ or have access to actuaries with experience in the insurance industry, other supervisors may have to limit their recruitment to persons with a more general background in mathematics, statistics and economics. In almost all member states, it is reported to be hard to recruit experienced actuaries, since it is difficult to compete with the private sector. The IAIS Core Principles support the need for a well-funded supervisory authority to reduce this problem.

40. In several jurisdictions, it is noted that the supervisor can call for an independent actuarial report to be made at the cost of the insurer. This can assist in addressing the problem of availability of resources within a supervisory agency.

Conclusion #7:

Where the use of a responsible actuary model is adopted, the supervisor should not simply accept the work of the actuary without further scrutiny, but should have access to actuarial resources to review and interpret the advice of the responsible actuary.

5. Issues to be considered regarding the use of actuaries

41. The use of actuaries as part of the supervision of insurers is fairly widespread. The actual model used in jurisdictions does vary, however. This section discusses a number of issues that are particularly relevant when a responsible actuary model is used, although many will also have a wider application to all jurisdictions where there are actuaries within the industry and the supervisory authority.

The requirement to have a responsible actuary

42. In almost all jurisdictions where there is a requirement for a responsible actuary, there is a legislative requirement to have a responsible actuary for life insurance. This requirement in these jurisdictions is often long standing and reflects industry practice, as well as having statutory support.

43. In several of these jurisdictions, the actuary proposed as the responsible actuary cannot be confirmed until the consent or approval of the supervisor is provided. Whether or not the system has a requirement for the supervisor to approve the appointment of an actuary may be based on philosophical or practical considerations. In particular, the key philosophical consideration is whether the supervisor believes that pre-approval of the appointment of individuals to various positions by insurers is appropriate. Practical considerations include the volume of approvals that may be required and the ability to define a set of criteria regarding qualifications, experience, and membership in a professional association that can be reasonably relied upon by the supervisor. An alternative supervisory approach to prior approval of the responsible actuary may be to rely on notification of appointment. In either case, the supervisor should have the ability to require replacement of the responsible actuary, if necessary.

44. While the requirement to have a responsible actuary in non-life insurance is less prevalent, some jurisdictions do have this legislative requirement. This requirement appears to be a growing trend, with some jurisdictions requiring approval of the appointment of the responsible actuary.

45. Even where a responsible actuary is not required in non-life insurance, the supervisor should review the technical provisions of the insurer, using actuaries or other staff employed by the supervisor or an independent actuary. In all cases, the role of actuaries in reviewing technical provisions is an important part of the supervisory model and involves oversight both within the insurer and in the supervisory authority.

46. While there is some consensus on the requirement to use an actuary, the role of the actuary differs across jurisdictions. For instance, some jurisdictions require the actuary to ‘certify’ or ‘attest’ to particular things, while others require the actuary to provide ‘advice’ only. Sometimes, in addition, a supplementary report must be prepared describing the actuary’s analysis, methods, assumptions, conclusions, etc. This is further discussed below.

Conclusion #8:

The appointment of a particular responsible actuary should be subject to supervisory review and the supervisor should have the capacity to have an unsatisfactory appointee removed from the position.

Definition of suitable candidates

47. In all responding jurisdictions, the requirements regarding who could be appointed as a responsible actuary are defined in the supervisory rules or legislation.

48. The criteria for a responsible actuary in responding jurisdictions include:

- Qualified by specified initial and ongoing educational requirements
- Membership in the local professional body at an appropriate level
- A minimum specified period of relevant practice as an actuary since qualification at that level
- A requirement that the responsible actuary be a resident of the jurisdiction (in some cases).

49. In some cases, actuaries who do not meet the standard criteria set out in the regulations or supervisory rules may be subject to separate approval by the supervisor on a case-by-case basis. However, the actuary should always be subject to the general fit and proper requirements that are applicable to others.

50. The existence of criteria for a responsible actuary ensures that persons with responsibility for providing advice on actuarial matters, such as the level of technical provisions, have appropriate qualifications and expertise and are capable of fulfilling the roles and responsibilities of a responsible actuary, to whatever extent is prescribed, with competence and integrity. Employing a minimum level of criteria ensures that the use of an actuary in the supervisory model is not undermined and contributes to confidence in the system.

51. Where membership in the local actuarial body is part of the criteria, then the supervisor needs to understand how the membership criteria are determined. In addition, membership criteria for a professional body may change explicitly or implicitly (for example, through a mutual recognition of qualifications earned in other associations). The supervisor needs to be able to monitor these changes and adopt criteria that may be more limiting than those of the professional body, if this is felt necessary and appropriate.

Conclusion #9:

Where a responsible actuary model is in place, there should be some criteria regarding who may qualify for appointment as a responsible actuary. These criteria may be based on qualifications, professional experience, membership in a professional association or a combination of these elements. In addition, factors such as the personal and professional ability to function in the position should be considered.

Avoiding conflict

52. In many jurisdictions, there is a limitation on the positions that someone appointed as a responsible actuary can hold. The rationale for this is to avoid any potential conflict of interest that may result from a responsible actuary also holding an executive position within the insurer.

53. In particular, when an actuary also holds the position of chief executive officer of the insurer it is considered less than ideal that this person should also be the responsible actuary. Some jurisdictions have an explicit prohibition on this situation, while others are able to enforce such a requirement without explicit legislative support.

54. Some responding jurisdictions also prohibit the responsible actuary from being a director of the insurer. In support of this argument, it is considered that an actuary who is also a director may be faced with substantial conflict if obliged to act as a 'whistle-blower'. On the other hand, some jurisdictions find that the opportunity for an actuary to also be a director raises the status of the actuary in the insurer. In some jurisdictions, there is also prohibition on the actuary being a chief financial officer.

55. In all responding jurisdictions, however, the actuary can be an employee of the insurer.

56. In almost all responding jurisdictions, the actuary can be a consultant, and in almost all of these, the actuary can be appointed for more than one insurer.

57. In addition to these limitations on the roles the responsible actuary can hold, some jurisdictions also require the actuary to disclose certain information, either to the supervisor or publicly, in an attempt to limit the risk of conflicts of interest. Examples of this would include the full disclosure, by the actuary, of potential, perceived or actual conflicts, or of the basis and level of remuneration from the insurer. Internal control mechanisms, such as an internal audit function, should be in place to identify any such conflicts.

58. There are also cases where an actuary of an insurer is also a policyholder of that insurer and may thus be ordinarily entitled to participate in the allocation of shares in an insurer on demutualisation. In such cases, where this is material, it may be prudent that the actuary advising on a demutualisation either seek to be excluded from the effects of such advice or not actually provide the advice.

59. As highlighted above, the supervisor would also have a role to play here, particularly in situations where the actuary is an employee of the insurer. The supervisor should actively assess the work of an actuary, or have access to resources such as an external actuary that can provide a peer review, to ensure this situation does not result in actuarial advice that is inappropriately biased.

Conclusion #10:

Where a responsible actuary model is in place, consideration should be given to potential conflict of interest situations. It is preferable that the person appointed as a responsible actuary not be permitted to hold this position at the same time as being a chief executive officer.

The removal of a responsible actuary from the position

60. Situations may arise where it is prudent for a responsible actuary to be removed from this position. Circumstances such as when an actuary fails to adequately perform required functions and duties, does not meet eligibility or fit and proper criteria, or is subject to conflicts of interest, are

examples of cases where removal may be warranted. Inadequate or inappropriate advice, if accepted by a Board, can potentially undermine the financial stability of an insurer and ultimately threaten the interests of policyholders.

61. Some supervisors have the ability to remove an actuary directly, while others can do this through the insurer.

62. In all responding jurisdictions, the actuary can be removed by the Board of the insurer (or senior governing body) and, in some cases, by the senior management. In the event that an insurer removes the actuary, it is usual for the supervisor to be made aware of the reasons for the change of responsible actuary. The supervisor should be able to address any concerns that may arise when an insurer removes a responsible actuary in an attempt to frustrate the role of the actuary or the actuary's advice. In cases where an actuary has been removed, it is also important that the new actuary communicate with the former actuary to determine whether there was any professional reason for the change.

Conclusion #11:

Where a responsible actuary model is in place, there should be some avenue available for a responsible actuary to be removed at the initiative of either the insurer or the supervisor. Removal may be required where the actuary fails to perform adequately the required functions and duties or does not meet eligibility or fit and proper criteria. The supervisor should be promptly informed in cases where the insurer removes the responsible actuary.

Professional associations

63. Professional actuarial bodies or associations can play a role in the development of a responsible actuary model. A well-organised actuarial profession will be characterised by several features, some of which are of particular relevance to the effective use of actuaries in the supervisory model.

64. The profession will ideally be defined by the existence of an actuarial professional body, which defines membership standards with reference to educational standards, professional competence and experience. One measure of the state of development of the profession is whether the professional body is able to meet the criteria for membership in the International Actuarial Association.

65. Further, the actuarial professional body can play the following additional roles:

- Provide support, resources and expertise to develop standard tables (e.g., mortality) which can be used as input in the development of suitable assumptions for valuation of technical provisions
- Provide research into the financial aspects of insurance
- Contribute to the development of professional standards of practice to ensure that the proper actuarial skills and procedures are applied and are the basis of the advice rendered and for all relevant issues to be addressed in preparing reports
- Provide a mechanism for peer review of the work of the responsible actuary[2]

[2] Peer review of the work of a responsible actuary is done by another senior and appropriately qualified actuary to ensure it complies with professional standards. It involves the sharing of best practice and experience from a wider range of sources than might otherwise be available to a responsible actuary. It provides an external and

- Require all members to adhere to a code of professional conduct, which emphasises ethical, honest and professional behaviour

- Establish requirements for each member to possess the appropriate qualifications (e.g., both basic and recent experience and training) before accepting an assignment, to ensure the quality of the professional advice rendered

- Provide continuing professional development opportunities to its members

- Provide a mechanism to hear complaints and administer discipline, so that members who fail to act in a proper manner are subject to appropriate sanction.

66. It is recognised that these various functions may be performed through one or more professional associations or through other arrangements made involving the members of the profession.

Conclusion #12:

A supervisory model that makes use of an actuary should take into account the extent to which the actuary is subject to professional standards of practice, qualification standards and obligations on professional conduct.

67. All responding jurisdictions have local actuarial associations within the jurisdictions. Some of the associations conduct their own examinations. Most associations have documented standards of practice and professional conduct that members are bound to follow.

68. Most associations also have disciplinary procedures should a member not satisfy the prescribed standards.

69. In some cases, the supervisor does not have an explicit power to make a complaint against an actuary to the professional body. It is desirable that the supervisory authority have the capacity to make a complaint, either formally or informally, without substantial risk of legal action being taken against it.

70. In drafting or redrafting their own rules, the professional associations consult directly with the regulator in several responding jurisdictions, and indirectly in others. In many cases, this consultation may include the supervisory authority collaborating with or being part of working committees of the professional association.

71. It is important that prudent actuarial valuation standards and practices be adopted. The need for the supervisor to assess those standards is an important prerequisite. The degree to which these standards are developed and implemented, and the existence and effectiveness of a professional code of conduct and a professional discipline system within the actuarial profession, will determine the reliance that can be placed upon the actuary in a supervisory system. The supervisor has a role in assessing the prudence of the standards. There are a number of ways that this can be achieved including:

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independent review, which should give comfort that the actuary has fulfilled the responsibilities to the insurer and the supervisory authority.

- having sufficient actuarial resources available within the supervisory authority to review the responsible actuary's work
- maintaining close relations with the actuarial profession
- having the authority to provide directions regarding the actuarial valuation practices
- requiring peer review of the work of the responsible actuary
- being able to engage an independent actuary to conduct a review of the responsible actuary's work
- having the capacity to lodge a complaint with the professional association when the responsible actuary's work or behaviour is found not to be in compliance with professional standards
- having the authority to replace the responsible actuary.

In the event that an official role does exist but the actuarial profession does not provide each of these elements to the satisfaction of the supervisor, then it is necessary for the supervisor to take alternative steps to ensure that the necessary elements are developed or for such requirements to be imposed directly by the supervisor.

Conclusion #13:

The nature of the professional associations should influence the supervisor's dependence on a responsible actuary. For instance, where professional codes of conduct, standards of practice and disciplinary procedures are in place, the supervisor may place greater reliance on these persons. The professional associations can also provide a forum for development of technical aspects of the actuarial role.

In any event, the supervisor has a role to ensure that practices are adequate and subject to review.

6. The specific role of a responsible actuary

72. This section considers the particular tasks that are required of the actuary under a responsible actuary model.

Requirements to provide advice to the insurer

73. Precise requirements for the actuary to provide advice on various matters vary from jurisdiction to jurisdiction. In addition, there is also variation in the extent to which the actuary may rely on subordinate actuaries and others for such things as data accuracy, assistance in performing supporting studies, etc. These requirements and limitations are locally established by legislation, regulation, professional standards of practice, or custom.

74. In all responding jurisdictions that require the use of a responsible actuary in life insurance, there is a requirement that the actuary provide advice on the establishment of the technical provisions.

75. In life insurance, requirements to provide advice on other aspects vary. For example, some jurisdictions may require the actuary to provide advice on items such as: the premiums to be charged

(the level of tariffs); the terms and conditions of insurance contracts; the risk assessment policies; the adequacy of reinsurance arrangements; the investment policy; and most require the actuary to provide advice on the determination of the allocation of profits, distributions or bonuses to participating life insurance policyholders. Transfers of profit, or the distribution of capital back to shareholders, may also be subject to a requirement for actuarial advice. In many cases, this advice is required to be formal and in writing.

76. Although not a common regulatory requirement in responding jurisdictions, the responsible actuary is sometimes seen as having an important fiduciary role to represent the interests of the policyholders, particularly the participating policyholders, when decisions are taken within the insurer.

77. In most responding jurisdictions that require the use of a responsible actuary in non-life insurance, there is a requirement that the responsible actuary provide advice on the establishment of the technical provisions.

78. With respect to non-life insurance, requirements to provide advice on other aspects vary. Some jurisdictions require the actuary to provide advice on: the premiums to be charged (the level of tariffs); the risk assessment policies of the insurer; the adequacy of reinsurance arrangements; and the risk control, particularly by means of claims statistics.

79. In some jurisdictions, the responsible actuary is required to do stress testing and provide results regarding the potential impact on the current and future financial condition of the insurer to management, the Board of Directors and the supervisor.

80. The responsible actuary should have direct access to the insurer's Board of Directors, as necessary.

81. It is also possible that the actuary may be used to provide advice on emerging risk management issues or on particular accounting issues.

Conclusion #14:

Where a responsible actuary model is in place, the role of the actuary should be defined in terms of the types of advice that the actuary is required to give the insurer, for various lines of business. The actuary should provide advice on the level of technical provisions. Consideration should also be given to other areas where advice of the actuary will be valuable, such as: levels of premiums; adequacy of risk assessment; reinsurance arrangements; investment policies; statistical inference; and stress testing of the future financial condition of the insurer.

Requirements to provide written reports

82. In line with the variation in the types of advice to be provided, the extent of reports to be provided also varies. The preparation of a report provides transparency and accountability, particularly if the report is written in a manner suitable to the needs of its target audience; the assumptions, methodologies and recommendations can be scrutinised and questioned. This enables the Board of an insurer to make informed decisions and allows the supervisor to ensure certain standards and practices are being followed.

83. In all responding jurisdictions that require the use of a responsible actuary in life insurance, there is a requirement that the actuary prepare a report and make it available to the supervisory authority in relation to the establishment of the technical provisions and, in most cases, in relation to the determination of the allocation of profits or bonuses to participating life insurance policyholders.

Some jurisdictions require that the actuary prepare a report in relation to the impacts of alternative scenarios on the current and future financial condition of the insurer. It is noted that the report is often prepared as a report to the insurer, with a copy sent to the insurance supervisor. The supervisor may have the power to override, or not accept, the whole or a part of the content of the actuary's report.

84. Some responding jurisdictions require a report to be prepared and submitted in relation to the premiums to be charged (the level of tariffs). Only one responding jurisdiction requires the actuary to provide a report on the terms and conditions of policies. In each of these jurisdictions, the supervisor can override the actuary's report. In other jurisdictions, there is no requirement that a report be submitted; however, a written report still needs to be prepared for the insurer and the supervisor may still override the actuary's advice. This ability to override the actuary's advice or report provides the supervisor with an additional supervisory tool to ensure it is satisfied in respect of prudential matters.

85. In all responding jurisdictions that require the use of an actuary in non-life insurance, there is a requirement that the actuary prepare a written report and make it available to the supervisor in relation to the establishment of the technical provisions.

Conclusion #15:

Where a responsible actuary model is in place, there should be a requirement for the actuary to prepare a written report on the technical provisions and for that report to be provided to the insurer and made available to the supervisor. Consideration should also be given to requiring the actuary to prepare reports on other areas of advice.

Conclusion #16:

Where reports or advice on particular aspects are provided, the supervisor should have the ability to act independently of the actuary's advice.

Whistle-blowing roles

86. In some jurisdictions, the responsible actuary has a direct obligation to 'whistle-blow', that is, an obligation to report to the supervisor any matter that the actuary thinks requires action to avoid the contravention of regulatory requirements or to protect the interests of policyholders. In other jurisdictions, the actuary has an obligation to whistle-blow should the actuary believe that the insurer has failed to take appropriate action, but must first report the matter to the Board and then to the supervisor. The system of whistle-blowing provides an additional level of confidence for the supervisor.

87. In some jurisdictions, the actuary has protections under the law in relation to prosecution. This qualified privilege is designed to ensure that the actuary provides full and frank information to the supervisor without fear of litigation. This protection may extend beyond the strict obligations of the statutory whistle-blowing requirements.

88. The whistle-blowing requirement should be accompanied by a requirement that the insurer provide all necessary information to the responsible actuary to enable the actuary to carry out this role.

89. The scope of the whistle-blowing role is usually closely defined.

Conclusion #17:

Where a responsible actuary model is in place, consideration should be given to whether whistle-blowing requirements should be imposed on actuaries. The existence of such obligations may both increase the confidence of the supervisor and provide a direct link between supervisors and actuaries. In fulfilling such obligations, the actuary should have protection under the law.

7. Future developments

90. As noted at the outset of this paper, the use of actuaries in life insurance has long been commonplace, while the use of actuaries in non-life insurance is less widespread. As there is a move towards the increased use of actuarial skills in non-life insurance, this will necessitate greater professional development, experience and expertise in this growing area.

91. Developments in actuarial and mathematical practices, including the growth of risk modelling, will have effects on the work of supervisory authorities and on auditors. There is a need for increased knowledge, skills and expertise in these practices, to ensure supervisory authorities keep pace with these developments and can fully understand their implications.

92. Although there are many national aspects of insurance markets and their actuarial issues, experience shows that the international exchange of ideas and information in this area is valuable and of increasing importance. Not only can this exchange of information assist in the development and improvement of supervisory systems, but it may also assist in moving towards the development of harmonised principles and practices internationally. Greater interaction among the supervisors and practitioners is necessary to keep abreast with international trends and practices.

Appendix A: references and contributors

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Contributors

The following member jurisdictions of the IAIS contributed to the paper by way of response to the IAIS Solvency Subcommittee survey and written comments on the paper:

Australia, Canada (OSFI and FSCO), Chile, Chinese Taipei, Denmark, France, Germany, Guernsey, IAA, Japan, Malaysia, Norway, Spain, Sweden, Switzerland, Uganda, United Kingdom, United States and the World Bank. The US response reported the general practices among the various states, noting that they were widely followed but not fully uniform.

Guidance Paper No. 8

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

STRESS TESTING BY INSURERS

GUIDANCE PAPER

October 2003

[This document was prepared by the Solvency Subcommittee in consultation with members and observers.]

Stress testing by insurers

Contents

1. Introduction

1. The IAIS adopted a paper in January 2002 entitled *Principles on capital adequacy and solvency*, which sets out principles that should underlie solvency regimes for the regulation and supervision of insurers, including principles regarding the level of solvency. This guidance paper on stress testing most directly addresses *Principle 10:*

- *Principle 10:* *Capital adequacy and solvency regimes have to be supplemented by risk management systems.*

However, stress tests are also relevant to many other principles, such as:

- *Principle 1:* *Technical provisions of an insurer have to be adequate, reliable, objective and allow comparison across insurers*
- *Principle 3:* *Assets have to be appropriate, sufficiently realisable and objectively valued*
- *Principle 4:* *Capital adequacy and solvency regimes have to address the matching of assets with liabilities*
- *Principle 5:* *Capital requirements are needed to absorb losses that can occur from technical and other risks*
- *Principle 6:* *Capital adequacy and solvency regimes have to be sensitive to risk*

- *Principle 7:* *A control level is required*
- *Principle 11:* *Any allowance for reinsurance in a capital adequacy and solvency regime should consider the effectiveness of the risk transfer and make allowance for the likely security of the reinsurance counterparty*
- *Principle 12:* *The capital adequacy and solvency regime should be supported by appropriate disclosure*
- *Principle 13:* *Insurance supervisory authorities have to undertake solvency assessment.*

2. In addition, the *Insurance core principles and methodology (2003)* includes the following:

- ICP 18 (Risk assessment and management):
  The supervisory authority requires insurers to recognise the range of risks that they face and assess and manage them effectively.

- Advanced criterion in ICP 20 (Liabilities):
  The supervisory authority requires that insurers undertake regular stress testing for a range of adverse scenarios in order to assess the adequacy of capital resources in case technical provisions have to be increased.

3. Stress tests are a necessary tool in assisting an insurer to manage its risks and maintain adequate financial resources to deal with those risks. Stress tests can be used to identify and quantify the impact of different stress scenarios on an insurer's expected future financial position, in the broad sense.

4. Stress tests are a tool for examining what might happen in a particular stress scenario. However it should be noted that they do not predict what will happen.

5. The purposes of this guidance paper are:

- to discuss the role stress tests should play in an insurer's overall risk management framework, and how such tests may assist the insurer to maintain sufficient capital adequacy and solvency

- to outline the important role stress tests play in assisting supervisors to undertake their role in assessing risks faced by insurers

- to outline how supervisors can use stress testing to assess the prudential strength of individual insurers

- to outline the supervisory considerations, such as the corporate governance regime, that need to surround an insurer's stress testing environment

- to provide an overview of the various factors that need to be considered in designing and undertaking stress tests, including a discussion of possible modelling techniques that can be used.

6. The purposes of this guidance paper are not:

- to show how stress testing can be used to assess the stability of the insurance sector or financial system as a whole

- to prescribe the form and extent of public disclosure of insurers' stress testing results

- to define the corrective measures that can be taken by supervisors.

2. Objectives of stress testing

7. The business of insurance is based on dealing with uncertainty. Therefore, an insurer needs to consider a wide range of possible outcomes that may affect its current and expected future financial position. Stress tests are a necessary risk management tool for both insurers and supervisors to ascertain whether insurers are financially flexible to absorb possible losses that could occur under various scenarios. All the effects of stress testing, both direct and indirect, on both sides of the balance sheet should be taken into account.

For insurance management

8. Stress tests are a necessary tool for insurance management. Such tests should be a fundamental element of an insurer's overall risk management framework and capital adequacy determination. Stress tests are appropriate tools for insurers to use in assessing the risks to which they are subject and in ascertaining their own limits on the risks that they are prepared to take. They should help the insurer in making decisions as to whether, and what, action is needed to ensure that it is not taking undue risks from its own or the supervisor's and policyholders' perspective. For many insurers, this may require a cultural change in their approach to risk management.

9. It is expected that prudent, well-managed insurers would undertake stress testing as a matter of good corporate governance, which should result in better internal controls, governance and risk management. To be truly effective, stress tests should be considered as a fundamental element in an insurer's overall risk management framework, rather than being viewed simply as a helpful tool for capital allocation purposes or as a way to monitor performance. The use of such tests should not be seen as a regulatory burden.

10. Stress testing should contribute to the understanding that the board and management has of the risks facing the insurer. To accomplish this, the board and management must understand the assumptions underlying the stress testing, as well as the results. Also, stress tests can help an insurer to develop and assess alternative strategies for mitigating its risks.

11. Specifically, such tests should be appropriate to the insurer's own risk profile. For example, stress tests should reflect the fact that each insurer does not underwrite the same classes of risks, accept the same level of risks, have the same distribution systems, employ the same reinsurance arrangements, have the same distribution of assets by investment type/grade or have the same operational systems and controls.

12. The stress testing should address significant adverse threats to the future financial condition of the insurer, rather than just mildly uncomfortable possibilities, so as to truly test the insurer's exposure and the sufficiency of its technical provisions and capital. To better inform the board and management of the insurer's exposure to risks, it is useful to determine how adverse a risk must be for it to impair the insurer's financial position. The insurer should use stress testing for strategic planning and for contingency planning.

For the supervisory process

13. The supervisor should receive the results of the most material stress tests and the critical assumptions underlying them, and have access to the results of all tests.

14. Where the supervisory authority considers that the stress tests conducted by the company should be supplemented with additional tests, they should be able to require that the insurer carry out such additional tests. Where the supervisor feels that the company's response to the results of the stress test is insufficient, it should be able to direct the company to develop a more prudent response.

15. There are circumstances where the supervisor may develop standard stress tests and require insurers to perform such tests. One purpose of such testing is to measure the level of consistency in the testing done by the insurers and thus to enhance the confidence in the stress tests performed by the insurers. Such tests may be directed at a single insurer, selected insurers or all insurers. The criteria for scenarios used for standard stress tests should be developed such that the risk environment of each jurisdiction is duly taken into consideration.

16. In some countries, in determining capital requirements, some degree of stress testing is required. In such cases, it would be expected that the level of risk tested is set at a level well below what is expected to be used in the more general stress testing addressed by this paper.

3. Scope of coverage

17. There are numerous definitions of what constitutes stress testing. For the purposes of this paper, the term "stress testing" includes both sensitivity testing and scenario testing. Both approaches are undertaken by insurers to provide a better understanding of the vulnerabilities that they face under atypical conditions. They are based on the analysis of the impact of unlikely, but not impossible, adverse scenarios. These stresses can be financial, operational, legal, involve liquidity or be related to any other risk that might have an economic impact on the insurer.

18. Specifically, a sensitivity test estimates the impact of one or more moves in a particular risk factor, or a small number of closely linked risk factors, on the future financial condition of the insurer. An example of a sensitivity test is the resiliency testing done in the U.K. and Australia. A scenario test, by comparison, is a more complicated type of test, which contains simultaneous moves in a number of risk factors and is often linked to explicit changes in the view of the world. Scenario tests often examine the impact of catastrophic events on an insurer's financial condition, particularly in a defined geographical area, or simultaneous movements in a number of risk categories affecting all of the insurer's business lines or trading operations, e.g., underwriting volumes, equity prices and interest rate movements.

19. There are two basic types of scenarios: historical and hypothetical. Historical scenarios reflect changes in risk factors that occurred in specific historical episodes. Hypothetical scenarios use a structure of shocks that is thought to be plausible, but has not yet occurred. Each type of scenario has its benefits. Depending on the risks, both approaches could be of value and should thus be used.

20. A large part of an insurer's financial management is based on an understanding of expected outcomes and the normal variation around these expected outcomes. An analysis of the financial effects of atypical or extreme scenarios is needed to gain a comprehensive view of the risk assumed, e.g., measuring the potential impact of a stock market collapse on the insurer's equity portfolio.

21. To measure the effects of atypical or extreme movements, there are numerous techniques that can be used in stress testing. These include deterministic modelling and various types of stochastic modelling[1], including Monte-Carlo simulation approaches. The risks that are stress tested must be

[1] The used of the word "stochastic" in this paper refers to both very sophisticated, complex methods, as well as to more simple models with a small number of random variables.

described and measured, including non-linear, asymmetric risks, such as options and prepayment risks. Various modelling techniques are discussed in Section 7 of this paper.

4. Required expertise

22. Each insurer should have access to the expertise and technology required to design and perform stress tests. This may involve a specialised risk management unit, actuarial personnel or external consultants.

23. Various individuals within the insurer, such as risk managers, finance personnel, actuaries and business line managers, should be involved in designing the stress tests. It may also be useful to consider other views, for example, those of the supervisor, external consultants, the accounting and actuarial professions, the reinsurance industry and rating agencies.

24. Those involved in designing the stress tests should have:

- a mix of expertise, which includes actuarial, accounting, economic, legal and financial expertise
- a thorough understanding of the business of the insurer
- the ability to identify risks that could potentially have a material adverse impact on the insurer's financial position
- the ability to undertake an analysis of how much of an impact these risks could reasonably have
- an understanding of the various models that can be used.

25. Those carrying out the testing must have the ability to analyse and effectively communicate the results.

26. Regardless of the level of expertise of those involved in designing the stress tests, a level of independence should exist to ensure that an adequate set of tests has been designed that is appropriate to the risk profile of the insurer. The decisions about the factors to be considered and the tests undertaken should be made, if possible, by those who are not involved in the corresponding business decisions. For a small insurer, it may be difficult to fully separate the decisions on stress testing from those involved in business operations.

27. In turn, insurers would be expected to be able to understand the results of the stress testing and to determine whether any aspect of their operations should be changed, given this knowledge.

5. Designing stress tests

28. It is appropriate that each insurer design its stress tests considering its own risk profile and the complexity of its business. It is likely that this will lead to variation among insurers as to the extent and nature of the tests performed.

29. There is benefit in considering stress scenarios even for risks that cannot be easily quantified or modelled. Examples of such risks include court rulings dealing with claims practices, reputational risk, changes in tax laws, etc.

30. Despite their limitations, supervisors may require, from time to time, some standardised tests in order to obtain a measure of consistency and for baseline monitoring purposes. These tests, however, should neither inhibit an insurer from undertaking its own thorough review of the inherent risks in its business, nor discourage an insurer from adopting an effective, comprehensive, risk-based approach to business management.

31. Various considerations are likely to determine the nature and extent of tests required. They include the insurer's:

- solvency position
- lines of business and distribution systems
- current position within the market
- current position within the group
- investment policy
- business plan
- general economic conditions.

For example, an insurer with a low solvency position should conduct more extensive or more frequent stress tests. An insurer within a larger corporate group should test the effects of possible changes resulting in constraints to accessing additional capital.

32. The insurer should consider what events are material, having regard to their impact and likelihood or plausibility. This, in part, will be a function of the insurer's size, complexity, solvency position and the nature of its operations and will depend on the insurer's risk tolerance.

33. The insurer should be able to withstand circumstances that are reasonably foreseeable, albeit unlikely, including events for which it is providing specific coverage.

34. In terms of specific elements, the following factors could be used as a guide to what insurers might consider when developing their stress tests. It should be noted that this is not intended to be an exhaustive list, especially as prescribed minima cannot cover all the specific risks within an insurer. Professional associations, such as an actuarial association, may also provide guidance on factors to be considered in developing stress tests.

Insurance risks

35. Insurance risk relates to the risk that an inappropriate underwriting strategy is adopted (e.g., involving an inappropriate pooling of risks and adverse selection), that the chosen strategy is inadequately implemented, or that unexpected losses arise even when an appropriate strategy is adequately implemented. Insurance risks specifically focus upon the impact of the underwriting and claims functions on an insurer's premiums and technical provisions. Insurance risks may be categorised as underwriting risk, catastrophe risk, or the risk of deterioration of technical provisions. Factors to consider include, but are not limited to:

Underwriting risk

36.

- the adequacy of the insurer's pricing, e.g., the insurer should be able to satisfy itself that it can charge adequate rates, taking into account the business, the terms of the policies, any options or guarantees, the premium cycle's effect on industry capacity and rate-levels and its own internal profit targets

- the effects of rapid growth or decline in the volume of the underwriting portfolio

- the uncertainty of claims experience, including the frequency and size of large claims

- the length of tail of the claims development and latent claims

- the dependence on certain intermediaries for a disproportionate share of the insurer's premium income

- the possibility of reinsurance rates increasing substantially or reinsurance becoming unavailable

- the effects of a high level of uncertainty in pricing in new or emerging underwriting markets due to a lack of information needed to enable the insurer to make a proper assessment of the price of the risk

- the geographical mix of the portfolio and any geographical or jurisdictional concentrations

- the tolerance for variations in expenses, including indirect costs, such as overheads.

Catastrophe risk

37.

- the ability of the insurer to withstand catastrophic events, increases in unexpected exposures, latent claims or aggregation of claims

- the possible exhaustion of reinsurance arrangements

- the appropriateness of the catastrophe models and underlying assumptions used, such as probable maximum loss (PML) factors.

Catastrophic events apply to all lines of business.

Deterioration of technical provisions

38.

- the adequacy and uncertainty of the technical claims provisions, e.g., outstanding claims, incurred but not reported claims (IBNR) and claims handling expense reserves

- the adequacy of other underwriting provisions, e.g., the provisions for unearned premiums and unexpired risks

- the frequency and size of large claims

- possible outcomes relating to any disputed claims, particularly where the outcome is subject to legal proceedings
- the effects of inflation
- the effects of increasing longevity on pension products
- the guarantees and options in policy terms
- the risks of early policy termination which can be linked to variations in interest rates
- social changes resulting in an increase in the propensity to claim or to sue
- other social, economic, legislative and technological changes.

Market risk

39. Market risk is concerned primarily with the adverse movement in the value of an insurer's assets and liabilities, both on-balance sheet and off-balance sheet, whose value may be affected by market movement. For insurers, it is the extent to which an adverse movement in the value of the assets as a consequence of market movements, such as interest rates, foreign exchange rates, equity prices, etc., is not offset by a corresponding movement in the value of the liabilities. Factors to consider include, but are not limited to:

- the possibility of a severe economic or market downturn leading to interest rate movements that adversely affect the insurer's financial position
- the impact of price shifts in asset classes on the entire portfolio
- inadequate valuation of assets
- the direct impact on the portfolio of currency devaluation, as well as the effect on related markets and currencies
- the extent of any mismatch of assets and liabilities, including reinvestment risk
- the impact on the portfolio value of a dramatic change in the spread between a market index of interest rates and the risk free interest rate
- the extent to which market moves could have non-linear effects on values, e.g., derivatives
- the effect of credit rating downgrades on the value of assets.

Credit risk

40. Credit risk relates to the possibility that a counterparty will fail to perform its obligations. Insurers' counterparties may include debtors, borrowers, brokers, policyholders, reinsurers and guarantors. Credit risk may also be assumed through guarantees and other financial instruments, such as derivatives and securitisations. Factors to consider include, but are not limited to:

- the collapse of a reinsurer or several reinsurers on the insurer's reinsurance program and the subsequent impact this may have on outstanding reinsurance and IBNR recoveries

- a deterioration in the credit worthiness of the insurer's reinsurers, intermediaries or other counterparties

- the degree of concentration of business with reinsurers of particular rating grades

- the degree of credit risk concentration, e.g., exposure to a single name or counterparty

- deterioration in the extent and quality of collateral

- greater losses from bad debts than anticipated

- defaults by parties in respect of whom guarantees have been given by the insurer, whether under insurance contracts or otherwise.

Liquidity risk

41. Liquidity risk relates to the possibility that an insurer will be unable to realise assets to fund its obligations as and when they fall due. Understanding whether an insurer's cash flow is sufficient to meet its commitments to policyholders and other creditors is fundamental. Factors to consider include, but are not limited to:

- any mismatch between expected asset and liability cash flows

- the inability to sell assets quickly

- the extent to which the insurer's assets have been pledged

- the cash-flow positions generally of the insurer and its ability to withstand sharp, unexpected outflows of funds via payment of claims, or an unexpected drop in the inflow of premiums

- the possible need to reduce large asset positions at different levels of market liquidity, and the related potential costs and timing constraints.

Operational risk

42. The *IAIS Glossary* defines operational risk as: "the risk arising from failure of systems, internal procedures and controls leading to financial loss. Operational risk also includes custody risk." This paper uses the term in a wider sense than the present Glossary definition.

43. While the application of stress tests to operational risks may not be immediately obvious, the insurer should at least be able to demonstrate that such risks have been considered and that appropriate plans and procedures exist to adequately deal with an adverse scenario. Operational risks may be very difficult to identify and measure. Factors to consider include, but are not limited to:

- the adequacy of an insurer's business continuity management (BCM) plans

- the adequacy of an insurer's disaster recovery planning (DRP), e.g., the potential failure of back-up systems, or failure in the efficiency and effectiveness of off-site back-up facilities

- the possibility of fraudulent activity occurring that may impact upon the financial condition or operational situation of the insurer

- the technological risks to which the insurer may be exposed, e.g., those relating to both the hardware systems and the software utilised to run those systems

- the reputational risks to which the insurer may be exposed, e.g., the impact on the insurer if its brand is damaged, resulting in a loss of policyholders from the underwriting portfolio

- the marketing and distribution risks to which the insurer may be exposed, e.g., the dependency on intermediary business

- the possibility of political interference, e.g., the confiscation of assets, restriction of movement of funds in an emergency situation or legislative changes, such as changes in taxation or mandatory coverages

- the impact of legal risks, e.g., the imposition of fines, or the risk that policy wording may be interpreted more broadly than intended

- the possible impact of any outsourcing difficulties, e.g., third-party providers failing to perform in accordance with their contractual obligations

- the failure of general personnel management controls, e.g., the impact of an underwriter exceeding authority limits.

Group risk

44. The membership of an insurer in a group can be a potential source of strength to the insurer, but it can also pose risks, particularly as a result of contagion. Factors to consider include, but are not limited to:

- the impact on the insurer if financial support is no longer being guaranteed by the parent or the insurer is unable to access additional capital or repatriate funds

- the effect on the insurer of an impaired parent or affiliate within the group, e.g., the impact on funding sources available, such as lines of credit, intra-group funding or access to external capital

- the effect on the insurer of the inability to sell or close a subsidiary in difficulty in a timely manner, e.g., where the subsidiary shares the same brand, systems and other infrastructure as the insurer

- the potential diversion of management time to group issues

- the implicit support of group companies through the reallocation of group overheads towards the insurance entity

- the pressure on the insurer to financially support other group members

- the pressure on the insurer to comply with group requirements rather than the firm's own strategy, e.g., with respect to investment mix

- the effect on the insurer of a high degree of dependence on group resources (e.g., through intra-group outsourcing) to support the insurer's critical operations

- the effect on the insurer of a downgrade in the rating of the group or of other reputational issues.

Systemic risk

45.

- the failure or downgrading of one or more significant insurer in a market could result in marketing or reputational risk for other insurers

- the failure or downgrading of other financial institutions, such as banks, in a jurisdiction could affect an insurer's operations.

6. Frequency and time horizon of stress testing

46. Stress tests should be conducted at least annually. In addition, stress tests should be conducted to capture new material developments and evolving portfolio characteristics. The decision on the appropriate frequency will be influenced by factors such as those mentioned in paragraph 31.

47. While it is normally appropriate to perform stress testing at least annually, less frequent stress testing may be appropriate for an insurer with a low risk profile. More frequent stress testing may be appropriate for an insurer with a high risk profile, or when market conditions are changing rapidly. Supervisors may require more frequent stress testing, e.g., quarterly, either as a general practice or in response to the particular circumstances of the market or an insurer. For such non-annual stress testing, the supervisory authority may require fewer details than is the case for annual stress testing.

48. Stress tests should examine the effects and impact that different time horizons will have on business plans, strategic risks and future operating requirements. The time horizon needs to be long enough for the effects of the stress to be fully evident, for management to act and for the results to emerge. For some risks, this may require stress testing over a complete economic cycle. For example, in Canada, life insurers project financial results for five years and non-life insurers for at least two years.

7. Modelling techniques used in stress testing

49. Various modelling techniques are used in stress testing. The use of a particular risk model will depend on the insurer's circumstances and approach to risk assessment and risk management. Common methods used are based on static or dynamic modelling and deterministic or stochastic approaches.

50. In its basic form, static modelling implies that the analysis of the insurer's financial position is at a fixed point in time, whereas dynamic modelling takes into account developments over a certain time period. Deterministic models examine the financial impact if a certain scenario occurs, whereas stochastic models also take into account the probability of various scenarios occurring.

51. A simple example of a static deterministic stress test is where an insurer, in determining its appropriate capital level, examines the effects of loss ratios on its balance sheet. The loss ratio is the

risk variable, and the impact on net assets is the resultant exposure. Such tests do not take into account the actual probabilities of the different loss ratios occurring.

52. Stochastic models are more advanced techniques. They are based on probabilities that predict how key financial parameters interact with each other over time, and generate a distribution of outcomes based on simulations of those parameters in the future. One of the advantages of stochastic modelling is that it provides an indication of the range and the likelihood of different financial outcomes occurring. This is useful in achieving a particular level of confidence in the solvency level, e.g., a 0.5% risk of ruin.

53. Stochastic models are useful, and at times essential, where the insurance contracts contain both embedded options and financial guarantees. In these circumstances, it is likely that stochastic modelling will be needed for financial statement purposes as well as for stress testing.

54. An example of a stochastic risk measurement technique is Value at Risk (VaR). VaR models, often used in banks, provide a probability-based boundary on likely losses for a specified holding period (e.g., 10 days to 1 year) and confidence level. TailVar (also known as Policyholders' Expected Shortfall) is more frequently preferred for modelling catastrophic type events. However, statistical models such as VaR have a limited ability to accurately capture what happens in exceptional circumstances or extreme events, since statistical inference is imprecise without a sufficient number of observations and, in any event, is based on extrapolation of past experience into an unknown future[2].

8. Model validation and documentation

55. The reliability of the models used should be regularly validated.

56. The choice of models and parameters requires judgment, and the reliability of results may be compromised by model and parameter error. Regardless of the models used by an insurer in its stress tests, periodic back-testing or other validation processes should be undertaken to verify results and ascertain the degree of accuracy within the models. Some related considerations are as follows:

- when stochastic models are used, an insurer should stress test assumptions and correlations to see how sensitive the results are to the assumptions and the model parameters. An error analysis should be carried out and considered when evaluating the results of the stress tests

- models should be reviewed by individuals not engaged in the development or regular use of the models, nor involved in the corresponding business decisions, and the results of such reviews should be documented

- robust change control procedures should be in place to ensure that model changes are identified, documented and audited

- there should be a process in place for ongoing analysis of changes in modelled results from one period to the next.

57. Back-testing is a process for validating the accuracy of a model against actual results. This analysis should demonstrate that actual results over a reasonable period of time are within the expected range produced by the models.

[2] While techniques exist under extreme value theory to better capture such risks, they are not yet widely used.

58. For many risks faced by an insurer, the potential degree and validity of back-testing may be limited. For example, analysing the stock market on an annual basis (in terms of an insurer's investment portfolio) may provide 100 years of data, but much of it is of questionable relevance. For legal changes, the relevance of historical analysis may be very limited. When catastrophic type events are analysed, models should be based more on the structure of the risk events than on past statistics only.

59. Models used for stress testing hedging and trading strategies should also be evaluated to identify critical assumptions, such as the nature and extent of a potential market move or the correlation assumptions used in pricing models.

60. The entire stress testing process should be well documented. A procedures manual should exist which:

- describes the basic principles of the stress testing approach
- documents the quantitative techniques used
- documents the design of the stress testing models
- lists the controls and procedures integral to the stress testing process
- describes the criteria used to determine the scenarios to be tested.

9. Complexity of scenarios and interactions among risks

61. The complexity of stress tests should be driven by the circumstances of each insurer. Straightforward tests, with simple assumptions that cover the major risks, may be more useful than complex modelling that is difficult to understand or to validate. However, it would be expected that a prudent, well-managed insurer would regularly examine the quality and content of such tests, and seek to improve the methodology over time.

62. Risks are seldom totally independent or totally related. The insurer should examine the correlations among various risks to assess the effects they may have on the stress testing models and assumptions used. It is important that the extent of correlation that is assumed to apply in the future is not understated. There is evidence that in adverse situations, previously low levels of correlation can increase. Determining interdependency requires judgment, as there may be no historical data that throws meaningful light on new social and economic conditions.

63. The correlation and the interdependency among risks should be regularly evaluated. While the frequency of such evaluation should normally be fixed in advance, it may need to be done more frequently in times of crisis.

64. The correlation analyses are required to ensure that the interrelationship of risks is taken into account. For example, if an insurer was affected by a major catastrophe, other parties on which it is dependent may also have been affected, such as:

- reinsurers on which the insurer is reliant to meet claims
- intermediaries who generate future business

- other service providers, who may be unable to meet their contractual obligations or provide a full service

- counterparties in the capital markets (e.g., after the 11 September 2001 terrorist attack).

65. One stress may lead to another (e.g., cause and effect chains) and thus one may have to look at multiple risks. There are normally consequent effects, often in less-measurable risks, which should be taken into account when determining scenarios. An example is a regulatory requirement to augment, rather than just replenish, capital depleted by the stress conditions. These interactions may not occur immediately, but may evolve over time.

66. Determining the extent of dependencies that exist can be complex. A degree of prudence and pragmatism will be required when making judgment. This is particularly the case when determining tail-dependencies.

67. An example of tail-dependency would be where there are two risks that are usually uncorrelated, but where an extreme event for one risk may lead to greater loss from the other risk than would ordinarily have occurred. For example, a major catastrophe may coincide with a stock market collapse. The effects of the latter may be greater than expected due to investor nervousness. The 11 September 2001 terrorist attack is an example of this, since ordinarily an airline catastrophe would not accentuate a stock market decline.

10. Modelling management actions

68. Stress testing should generally consider the extent and effectiveness of options available to management in reacting to emerging risks. It is possible for a stress test to show a possibility of failure if no management action is assumed, but then be able to demonstrate that, with appropriate and timely management action, it is possible for an insurer to maintain a satisfactory financial condition.

69. There are many areas within an insurer's business that do not lend themselves easily to quantitative modelling, especially those that depend on the competence of, and actions taken by, an insurer's board and management.

70. The role of senior management is to develop and implement risk management policies, procedures and practices that translate the board's goals, objectives and risk limits into prudent operating standards. However, determining whether this role will be properly fulfilled requires judgment when performing stress testing.

71. Also difficult to quantify are:

- whether management decisions or actions are based on sound and prudent information or analysis

- issues surrounding staff recruitment and development

- whether too much reliance is being placed upon key persons.

72. Such considerations should form part of an insurer's overall risk management policies and procedures and, where possible, realistic estimates should be made of how quickly and how effectively the insurer will react to change. The speed assumed in modelling corrective action should be

consistent with the management culture, past experience and the existence of robust procedures for the identification of risk events so that management is able to respond in a timely manner.

73. When incorporating management actions into the stress testing, the following procedures should be followed:

- the impact of the stress event should be quantified and reported, without incorporating any management actions
- careful consideration should be given to the time it would take for management to recognise and respond to the problems, given the terms and conditions of policies and practices to be adjusted, and the extent and effectiveness of options open to management to act in response to the stress event
- the type and timing of the management actions should be incorporated in the stress test projection, and then be quantified and reported.

11. Limitations of stress tests

74. As a concept, stress testing is relatively straightforward. However, the application of this technique in practice is more complicated. Some of the difficulties are:

- determining what risk factors to stress
- establishing how such factors should be stressed
- establishing what range of values should be used
- determining the time horizon that such tests should consider
- meaningfully analysing the results and making informed judgments.

75. Another factor that insurers need to consider is that stress tests usually require good information systems and compatibility across business units, to properly analyse the interrelationships of risks. Internal communication flows among an insurer's business units are therefore important, particularly if there is not a dedicated resource area to undertake stress tests.

76. The extent to which parameters and variables are reliable should be reflected in the interpretation of results and resulting recommendations.

77. Reviews should occur regularly to ensure that they remain relevant to the changing risk profile of the insurer and external market conditions.

12. Reporting to board and management

78. A written report should be prepared that summarises the stress testing performed. This report should contain the following information:

- a description of the stress testing methodology and the key assumptions used in the stress testing models
- the results of the base case, e.g., using the same assumptions as the insurer's business plan
- the assumptions used in the stress testing scenarios and the interactions built into the models
- the results of the stress testing, before any management actions
- the extent to which data limitations affect the conclusions of the analysis
- the nature and timing of any management actions assumed in the models to mitigate the results of the adverse stress testing scenarios
- the results of the stress testing, including management actions.

79. An interpretive report is more desirable than a purely statistical report. In addition to a written report, an oral presentation that permits questions and discussions is desirable.

80. It is essential that the assumptions and results be presented in a manner that can be understood by an insurer's board and management and acted upon.

81. A report to the board and management should be prepared at least annually, unless stress testing is being performed less frequently (see Section 6).

82. The timing of the report may depend on the urgency of the matters reported and on the desirability of integrating stress testing into the insurer's financial planning cycle.

83. In some cases, a change in the insurer's circumstances since the last regular stress testing investigation may be so significant that to delay further testing and reporting to the time of the next regular report would be imprudent. In such a case, stress testing should be undertaken, and results reported, on an interim basis.

13. Public disclosure issues

84. This paper is not intended to provide guidance on public disclosure, but it gives some considerations regarding the decision by the supervisors in each jurisdiction on the level and form of public disclosure.

85. The existence of stress testing could form part of the information conveyed to external stakeholders who would have an interest in the level and quality of corporate governance within the insurer. Public disclosure of the broad outline of the nature of the tests that have been undertaken and how their results are used would allow stakeholders to understand the risk management capabilities of the insurer and to assess its underlying governance, policies, practices and systems.

86. If public disclosure goes further by disclosing the actual financial results of the stress test scenarios, various external stakeholders, such as insurance brokers, creditors, rating agencies, shareholders and policyholders could use this information to assist in their assessment of an insurer's ability to withstand adversity. Specifically, they could consider the effects such stresses would have

on the insurer's ability to meet policyholder liabilities and other obligations, and its future solvency position more generally.

87. It should be considered, however, that stress testing is a key risk management tool to help insurers to understand the consequences of extremely adverse situations. Stress testing might not achieve this key objective if insurers were required to publicly disclose the actual test results. Public disclosure requirements could discourage insurers from testing truly adverse scenarios. In addition, full disclosure may expose insurers to predatory actions by competitors and counterparties.

88. In deciding on what level and form of public disclosure of stress testing will be required, the supervisor should consider the possibility of misinterpretation of results, which may impact public confidence.

14. Use of the results by supervisors

89. The availability of stress testing information to the supervisor will enhance prudent supervision. On a routine basis, the supervisor should receive the results of the most material stress tests and the critical assumptions underlying them. The supervisor should also have access to full details on the assumptions and methodology used by the insurer in its stress testing. This will give the supervisor greater insight into the internal controls and specific risk management practices used by the insurer to manage its various risks.

90. When a supervisor prescribes standard tests, this assists the supervisor in benchmarking and comparative analyses. It may also enable the supervisor to quickly identify which insurers are likely to be affected by a major risk event, such as a natural disaster or the failure of a major reinsurer.

91. Where the stress testing results indicate an unsatisfactory prudential outcome, the supervisor should assess the insurer's response. If necessary, the supervisor may require the insurer to increase its capital, strengthen its systems and controls, or amend its business plan and strategies. The supervisor may also require the insurer to perform additional stress testing, to provide both the insurer and the supervisor with a more complete understanding of the situation.

92. The supervisor should be in a position to recognise which models have been useful in the past in the recognition and management of risks for insurers. However, the supervisor should generally not specify the use of a particular model for a particular insurer. The choice of the model and its appropriate use should be the responsibility of the insurer.

93. It would be appropriate for the supervisor to establish the requirements for stress testing for prudent risk management purposes for the insurer, e.g., the nature and minimum frequency of such tests. Some jurisdictions, in addition to requiring stress testing, may also prescribe broad minima for the factors that the testing must address.

Guidance Paper No. 9

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE PAPER ON INVESTMENT RISK MANAGEMENT

OCTOBER 2004

This document was prepared by the Investments Subcommittee in consultation with members and observers

Guidance paper on investment risk management

Contents

1. Introduction

1. The main focus of prudential regulation and supervision of insurers is usually considered to be the protection of the rights of policyholders. This includes oversight of the continuing ability of insurers to meet their contractual and other financial obligations to their policyholders. The nature of insurance business implies the establishment of technical provisions, and the investment in and holding of assets to cover these technical provisions and a solvency margin. The interplay between the characteristics of the insurance liabilities and the assets backing those liabilities is one of the most important sources of risks to insurers and hence one of the most important aspects of its operations for an insurer to manage. Investment management should therefore be undertaken as part of the overall asset liability management of the insurer. IAIS recognises that asset liability management is a topic for a separate paper. However, insurers also need to specifically control the risks associated with their investment activities, which is the focus of this paper.

2. This paper provides guidance on effective investment risk management for insurers and reinsurers and highlights issues applicable to the management of market risk, credit risk, and liquidity risk. The paper also provides guidance for the supervisor when evaluating investment risk management policies and practices of insurers, including the main set of data and documents the supervisor should consider when assessing and monitoring the investment risk management of insurers.

3. This guidance paper mainly addresses the insurer's investment risk management procedures, referred to in some jurisdictions as the "prudent person" approach. Elements of this approach can also be useful for other jurisdictions which are more prescriptive in nature. Insurers and supervisors should use judgment in assessing to what extent the guidance in this paper is relevant to their jurisdiction and does not create an unnecessary regulatory burden.

4. For the purposes of this paper, ‘insurer’ describes any corporate body or individual that is operating as an insurer or reinsurer, which is subject to insurance regulation, whether they be a domestic or a global insurer. Financial conglomerates may be considered within the scope of this document as far as they involve insurance activities.

5. Risk management is the process whereby the insurer's management takes action to assess and control the impact of past and potential future events that could be detrimental to the insurer. These events can impact both the asset and liability sides of the insurer's balance sheet, and the insurer’s cash flow. Investment risk management addresses investment related events that would cause the insurer’s investment performance to weaken or otherwise adversely affect its financial position. Various investment risks tend to focus on different parts of the investment portfolio. Market risk impacts capital investments, including stocks and real estate, as well as the bond and mortgage portfolios. Credit risk is present in the insurer’s lending activities, typically in the bond and mortgage portfolios. Liquidity risk is concerned with current and future maintenance of appropriate levels of cash and liquid assets, particularly in the context of the demands for liquidity that are imposed by the insurer’s liability profile. A variety of other risks, including operational and legal risk, also arise from investment activities.

6. Jurisdictions may approach investment risk management issues by imposing regulatory constraints on the investment policies and procedures of insurers, by placing restrictions on the categories of assets which may be used to cover technical provisions and the extent to which they may be used for that purpose, and/or by setting specific requirements on the matching of assets and liabilities. Accordingly, appropriate investment risk management policies, as detailed in this guidance paper, are in addition to these regulatory requirements.

7. As a result of regulatory change and globalisation of financial services, together with the growing sophistication of financial markets, the activities of insurers (and thus their risk profiles) are becoming more diverse and complex. In jurisdictions allowing their use, the inclusion of derivatives, or structured products that have the effect of derivatives, as part of the portfolio management processes, has become common practice. In order to be able to manage these diverse and complex risks, the insurers should organise themselves and act according to best practices applied to the business they conduct. The quality and quantity of their resources should be appropriate to the nature and complexity of their business.

8. This paper should be considered in conjunction with other principles, standards or guidance papers developed by the IAIS, in particular the *Principles on capital adequacy and solvency*, the *Solvency control levels guidance paper* and the *Stress testing by insurers guidance paper*. Given the particular importance of the liability structure in determining the investment policies, and the key role of asset liability management for insurers, this paper should be considered together with any IAIS work thereon.

9. The paper contains guidance supporting a number of the IAIS insurance principles. It addresses in part the principle 10, on "*Risk management*" of the January 2002 *Principles on capital adequacy and solvency* that sets out principles that generally underlie solvency regimes for insurers. Furthermore, investment risk management is relevant to many of the *Insurance Core Principles* adopted in October 2003, including:

- *Principle 1: Conditions for effective insurance supervision*
- *Principle 2: Supervisory objectives*
- *Principle 9: Corporate governance*
- *Principle 10: Internal control*
- *Principle 11: Market analysis*
- *Principle 18: Risk assessment and management*
- *Principle 21: Investments*
- *Principle 22: Derivatives and similar commitments*

10. The responsibility for investment risk management lies with the insurer. The insurer should demonstrate to the supervisor compliance with the relevant guidance outlined in this paper. The application of this guidance by the supervisor should be sensitive to the risk profile of the insurer and should take into account the size, nature and complexity of the business of the insurer. The scope of the application and review should be tailored to the supervisor's own regulatory framework.

2. Investment management by insurers

11. The characteristics of liabilities are the driving force in developing investment policies for an insurer. The nature of the insurance business conducted and the nature, terms and conditions of the policies written require the establishment of technical provisions, and the investment in assets which are appropriate to the insurer's liabilities. The design and underwriting of products, and thus the resulting liabilities of an insurer, cannot be considered in isolation from its investment activities. In order to ensure that it can meet its contractual liabilities to policyholders, an insurer should manage its assets in a sound and prudent manner, taking account of the profile of its liabilities, its solvency position and its complete risk-return profile.[1] This forms the essence of the insurer's asset liability management policies.

12. The complete risk-return profile is of particular importance in insurance businesses in so far as insurers are, by nature, risk transformers and their primary function remains risk mitigation. The associated risk level should be compatible with the effective protection of policyholders. It should result from an integrated view of the insurer's business, organisational structure and strategy, taking into account its:

- product and underwriting policies
- reinsurance policies
- asset liability management policies
- solvency level policies

1 See the definition of "complete risk-return profile" in the IAIS Glossary of Terms

- investment management policies.

13. Insurers should manage their business taking into account all risks. The focus of this guidance paper is investment risk management, including market, credit and liquidity risk. The relative importance of market, credit and liquidity risk will vary depending on, for example, business line, investment strategy and regulatory framework.

14. Consideration should also be given to operational risks within investment activities. For insurers, operational risks can be described as risks of direct or indirect loss resulting from inadequate or failed internal processes, people or systems. They would include, for example, risk arising from failures in corporate governance, systems, outsourcing arrangements and business continuity planning.

15. Given the insurer's profile of liabilities, the investment policies should ensure that the insurer holds sufficient assets of appropriate nature, term and liquidity to enable it to meet the liabilities as they become due. Thus, investment management should be performed as part of the overall asset liability management of the insurer. Key influences on investment decisions include the legal, regulatory, accounting and taxation environment, the various types of insurance business conducted, marketing literature and the availability of assets.

16. The timing and amount of insurance benefit payments is usually uncertain and in some cases sensitive to changes in financial markets (i.e. policyholder behaviour can be related to expectations in financial markets, relative investment performance and quality of customer service). Furthermore, the business of insurance usually involves a mismatch, in timing or amount, between receipt of premium income and payment of expenses and policy benefits. It is important for an insurer to monitor and assess the volatility of its income together with the volatility of its outflows, with respect to size and frequency of both expected and exceptional situations.

17. Detailed analysis and management of this asset and liability relationship will therefore be a pre-requisite to the development and review of investment policies and procedures, which should seek to ensure that the insurer adequately manages the investment related risks to its solvency. At a minimum, investment policies would be expected to address each of the following areas:

- asset and liability considerations, including asset liability management policies
- financial market environment
- eligible asset classes
- amount of delegated limits by management level
- strategic asset allocation
- conditions under which the insurer can pledge or lend assets
- maximum allowed deviation from strategic asset allocation (for example, tracking error)
- capital considerations
- solvency and liquidity considerations
- concentration risk
- risk parameters, including the investment risk management policies or reference to them.

18. Investment policies and procedures should be reviewed regularly and kept up-to-date. Such reviews should be formally documented and approved by the insurer's senior management and its board of directors.

19. Ultimate responsibility for the determination, implementation and monitoring of compliance with the overall investment strategy and policies and procedures and the compliance with legal requirements remains with the insurer's board of directors. However, elements of the implementation of investment management and investment risk management policies may be outsourced (for example, to external investment managers or brokers). Therefore, management of the risks associated with outsourced arrangements also needs to be considered. The insurer should establish outsourcing policies and require compliance with the investment policies defined and with the specific control guidelines regarding the outsourced functions.

3. Investment risk management framework

20. The insurer should have an effective investment risk management framework. In jurisdictions regulating investments and investment procedures of insurers, the investment risk management framework should adhere to any regulatory requirements in relation to investment policies, asset mix, valuation, diversification, asset and liability matching, and risk management. The framework should include: setting market, credit, liquidity and other investment risk management strategies and policies; developing management procedures to ensure that investments are only transacted in line with these policies, and; having an appropriate system of measurement, monitoring, reporting and control underpinning the investment activities.

21. At a minimum, the investment risk management framework should include:

- a description and criteria for measuring each of the investment risks to be monitored
- market risk
  - credit risk
  - liquidity risk
  - operational risk
- compliance policies
- reputation risk management policies
- control procedures, including risk tolerances
- reporting format and frequency.

22. The exact approach to the insurer's investment risk management will depend on a wide range of factors, including the size, level of sophistication and complexity of the insurer's activities. Regardless of the approach, basic principles such as the board of directors' and senior management's responsibility, the need for an investment policy, segregation of duties and appropriate controls should be applicable to all insurers.

23. The quality of the assets and related risks should be clearly communicated and understood throughout the organisation. Special management procedures, monitoring and controls have to be established on riskiest activities, such as complex operations, structured assets with embedded options and blind investments.[2]

2 See the definition of "blind investments (or pools)" in the IAIS Glossary of Terms

Role of the board of directors

24. The board of directors is ultimately responsible for ensuring that sound and comprehensive investment and risk management policies, which adhere to applicable regulation, are developed and for ensuring compliance with these policies. In most cases, the board will delegate the development of these policies to management for its approval, recognising that the policies remain its responsibility. The board should require that processes are in place to enable management to report and demonstrate compliance with these policies on a regular basis. Reporting should include instances of non-compliance and actions taken or planned to bring the insurer back in line with policies.

25. The board of directors is responsible for the determination and periodic review of the overall risk tolerance of the insurer and overseeing senior management in the formulation of the overall investment strategy. The board should take into consideration the insurer's assets and liabilities, regulatory requirements, and the insurer's solvency position. Based on the overall investment strategy, senior management sets the operational policies and procedures and assigns responsibilities. The board should ensure that adequate controls, including management reporting and internal audit, are in place to monitor that investments are being managed in accordance with the investment policies and regulatory and other legal requirements.

26. The board of directors should include members possessing knowledge and understanding of the insurer's markets, products, and risk management and of the markets and products in which the insurer invests. Any committees involved in investment risk management, such as an asset liability committee, should comprise of members possessing such knowledge and understanding.

27. The board of directors should:

- establish, maintain, and regularly review the process for identifying investment risk on existing and new products on both sides of the balance sheet
- set out the process for recommending, approving and implementing decisions
- identify potential sources of conflict of interest and establish procedures to ensure that those involved with the implementation of the investment and lending policies understand where these situations could arise and how they should be addressed
- assign responsibility for investment risk identification and assessment to a person or persons who are independent of the investment function.

Investment risk management function

28. In order to manage investment risk effectively the insurer should clearly identify measure, monitor and control the risks inherent in the investment portfolio. The methods and tools used to measure those risks should be appropriate for the nature and complexity of the risks assumed in the portfolio. Where the methodology is based on external sources (for example, rating agencies), it should make an assessment of the appropriateness of using and continuing to use those sources.

29. Investments risk exposures should be clearly defined and measured, using appropriate risk measurement methods on an ongoing basis. These methods should also be used for establishing

and monitoring risk limits and tolerances. Further, an insurer needs to be able to measure and document the overall amount of risk in its business, which includes the risk in its investment portfolio.

30. In constructing the risk management framework, the insurer should take into account possible material changes in correlations between different products, and between different business lines, on both sides of the balance sheet under stress scenarios. For example, increasing liabilities arising from real estate insurance written may correlate with increased market or credit risk on real estate related assets such as mortgage backed securities.

31. Where an insurer is a member of a conglomerate or group, the group should be able to monitor investments risk exposures on an aggregated basis. An insurer should also be able to demonstrate that it meets the risk management standards on a legal entity and business line basis where applicable. This is particularly important for subsidiaries of groups subject to matrix management where the business lines cut across legal entity boundaries.

32. Insurers should have information systems and analytical techniques that enable management to measure the risk inherent in all investment activities, on and off-balance sheet. The level of sophistication for analysis should be commensurate with the potential materiality of exposures.

33. The insurer should understand the source, type and amount of risk that it is accepting across all lines of business. For example, where there is a complex chain of transactions it should understand who has the ultimate legal risk or basis risk. Similar questions arise where the investment is via external funds, or blind pools. The insurer should have robust reporting lines and staff of sufficient quality and experience to make the risk assessments. It should also have an appropriate methodology to measure its risk.

34. The investment risk management function should assess the appropriateness of the asset allocation limits in the insurer's investment strategy periodically. To do this, regular stress testing should be undertaken for market scenarios, and changing investment and operating conditions appropriate to the insurer's own risk profile.[3] Once an insurer has identified the most risky scenarios, it should ensure that its investment policies and procedures are sufficiently defined to ensure the effective management of those high-risk situations.

35. Insurers should have contingency plans on hand that describe the action to be taken under a variety of extreme scenarios. These plans should be reviewed and updated regularly and management should be fully briefed on the plans.

Internal audit

36. In order to adhere to good corporate governance practice, an insurer should have a process (for example, an audit committee of the board) that approves the audit program. Internal audit should provide independent assurance to the board, its audit committee or an appropriate senior manager of the integrity and effectiveness of the insurer's systems and controls for investment risk management, and should make recommendations, where appropriate.

3 The use of scenario testing as a measurement tool is contained in the IAIS *Stress testing by insurers guidance paper*.

37. Internal audits should be conducted to review the insurer's compliance with overall risk management policies (including asset liability management) and procedures. An insurer should establish a system of independent, ongoing assessment of its investment risk management processes and the results should be communicated directly to the board of directors, its audit committee, and/or senior management according to their materiality.

38. Internal auditors should have the requisite level of training and expertise in investment risk management in order to be effective.

Compliance

39. The board of directors and senior management should ensure that a named individual is responsible for all compliance matters and that individual should be independent of the risk-taking units. The insurer should have a process for the dissemination of compliance information, ensuring that it has up-to-date staff training, and that regular compliance reports are produced. Further, it should ensure that there is a procedure to ensure the monitoring of compliance with the overall investment strategy, policies and procedures, legal and regulatory compliance requirements, and the notification of compliance breaches and senior management response and follow up. Senior management and the board of directors should receive regular, timely reports on compliance.

40. A proposed investment decision should have adequate documentation demonstrating that the decision is in compliance with the investment policies and the investment risk management framework.

Control procedures

41. The insurer should have sufficient internal controls, operating limits and other practices to ensure that investments risk exposures are maintained within levels consistent with prudential standards and risk tolerance, as defined by internal limits. An insurer should also have procedures for taking appropriate action according to the information within its management reports.

42. These procedures should address exposures arising from both on-balance sheet and off-balance sheet items.

43. Investment decisions and their execution are subject to the approval authorities described in the insurer's investment policies. There should be governance procedures surrounding both the investment strategy decision making (such as choice of markets and sectors) and investment transaction decision making (such as stock selection). The rationale and approval process for such decisions should be documented and maintained by the investment risk management function. Where material, the documentation should include:

- the rationale and recommendation for the investment decision (this may include documentation of other possible alternatives and the reason(s) why the recommended strategy was chosen)
- the level of risk that will result from execution of the investment decision

- presentation to the appropriate approval authorities
- evidence that the appropriate authority was obtained
- evidence that the decision was executed as authorised (no variation in the terms of the decision) within a specified time frame.

44. The measurement criteria defined for each of the investment risks being monitored should be compared with its risk tolerance on an ongoing basis. Proposed changes in the strategic or tactical allocation should be given a time horizon in which the changes should be executed.

45. When entering into or varying an outsourcing arrangement for aspects of investment related activities, an insurer should consider how the proposed outsourcing will:

- affect its risk level
- comply with regulations, where applicable
- how it will assess the service providers' financial viability
- how it will assess the concentration and liquidity risk implications.

The insurer should also ensure smooth transition when entering, ending or varying the arrangement.

Reporting

46. Procedures and formats for reporting to senior management, the board of directors, auditors and regulators should exist within the investment risk management policies. Reports may differ in design and level of detail included for each of these users. Procedures should include defining where the responsibility for production of each of the reports resides, the layout of each of the reports, and the timing of production and delivery. Reports should include a presentation of the results of the measurements used to assess each of the investment risks broken down by asset class, compared with the constraint outlined in the investment risk management policies. Reports should describe the method for classifying assets and the basis for valuing assets that are not regularly traded.

47. There should also be a presentation of special situations that may fall outside of the normal operations addressed by the policies (for example, special liquidity requirements as they may arise during acquisition or sale of a business unit). Where guidance on a future course of action is needed, reports should list possible alternatives with discussion of their merits and risks, and, if possible, a recommended course of action for management or board approval.

48. An insurer's internal controls should ensure that exceptions to policies, procedures and limits are reported in writing in a timely manner to the board of directors and to the appropriate level of management for action. The reporting on implementation of the investment risk management policies should address compliance with the key elements of the policies such as:

- target markets and approved products
- portfolio concentration limits
- approval authority limits
- investment limits
- rating systems

- the granting, acceptance and quality of the collateral
- minimum required transparency, where applicable (for example, blind pools or hedge funds).

49. The insurer should have compliance procedures to monitor that reviews have taken place, appropriate scenario/stress testing of the investment portfolio performed, decisions taken by the appropriate level of staff, and financial information is regularly and accurately updated.

50. Particular attention should be given to compliance procedures to monitor that the investment risk that does not conform to the usual investment risk policies or that exceeds predetermined risk limits and criteria, but is approved because of particular circumstances, and is in accordance with the insurer's procedures. In those cases, there should be monitoring of the associated conditions and of the remedial plan.

51. Unauthorised exceptions to policies, procedures and limits should be reported in a timely manner, as appropriate to the nature of the breach, to the appropriate level of management together with the remedial action proposed and/or taken.

4. Market risk

52. Market risk is introduced into an insurer's operations through variations in financial markets that cause changes in asset values, products or portfolio valuations.

Definitions

53. Market risk is the risk to an insurer's financial condition arising from adverse movements in the level or volatility of market prices. Market risk involves the exposure to movements of financial variables such as equity prices, interest rates or exchange rates. It includes the exposure of derivatives to movements in the price of the underlying instrument or risk factor. Market risk also involves the exposure to other unanticipated movements in financial variables or to movements in the actual or implied volatility of asset prices and options. Market risk incorporates general market risk (on all investments) and specific market risk (on each investment).

Identification

54. Market risk includes:

- interest rate risk: risk of losses resulting from movements in interest rates; to the extent that future cash flows from assets and liabilities are not well matched, movements in interest rates can have an adverse economic impact
- equity and real estate risks: risk of losses resulting from movements of market values of equities and other assets; to the extent the insurer makes capital investments, including stocks and real estate, the insurer is exposed to sustained declines in market values
- currency risk: risk of losses resulting from movements in exchange rates; to the extent that cash flows, assets and liabilities are denominated in different currencies, currency movements can have an adverse impact on the insurer.

55. Some insurers have sold investment products that guarantee return of policyholder capital, and may include a guaranteed minimum return or offer other forms of embedded options. This risk is generally not diversifiable but increases directly with the amount of such business that is sold. Insurance policies which contain guaranteed values, supported by investments, whose values rise and fall with market conditions, may experience the adverse effects of this type of market risk.

Measurement and management

56. An insurer should be able to measure its market risk exposure across risk factors (i.e. interest rate, equity and currency) and across the entire portfolio. The insurer should set appropriate metrics to measure exposure to market risk factors.

57. An insurer with a complex portfolio is expected to demonstrate more sophistication in its modelling and risk management than an insurer with a simple portfolio. Some trade-off is permissible between the sophistication and accuracy of the model and the conservatism of underlying assumptions or simplifications.

58. Various methods can be used to hedge market risk. An insurer should document the appropriate products to be used to hedge exposures, the items that can qualify to be hedged, how hedging instruments' effectiveness will be assessed and identify individuals responsible for monitoring hedge performance.

59. An insurer should set an appropriate limit structure to control its market risk exposure. The degree of granularity[4] within the limit structure, or how hierarchical it is, will depend on the nature of the products involved (for example, whether the risks are linear or non-linear), the scale of the insurer's overall business, and whether the insurer has an active or passive investment style. An insurer should set limits on risks such as interest rate risk and equity risk as well as more complex, non-linear factors arising from optionality.

60. The insurer should determine whether the market risk measures for different products should be added, compounded, have offsetting characteristics, or be combined in a more complex way.

61. Market risk limits should be periodically reviewed in order to verify their suitability for current market conditions and the insurer's overall risk tolerance. An insurer should use a model or some form of analytical tool to assess risk in complex instruments or across portfolios. The insurer should evaluate the risks arising from such business independently from those who trade market risk.

62. An insurer should also use stress testing to determine, amongst others, the potential effects of economic shifts, market events, changes in interest rates, changes in foreign exchange and changes in liquidity conditions. Particular attention should be given to the relevance and to the reliability of the underlying assumptions.

4 In this context, granularity refers to the level of detail in policies used to set exposure limits. At a high level, limits may be set with respect to asset class exposure. At a more detailed level, limits regarding specific industries, geographic areas, or even specific issuers may be considered.

63. Sufficient records should be retained to enable the insurer to perform back testing of methods and assumptions used for stress and scenario testing and for back testing of market risk models such as Value at Risk (VaR).

5. Credit risk

64. For most insurers, extending credit through investment and lending activities comprises an important portion of their business. Therefore, the quality of an insurer's credit portfolio affects the risks borne by policyholders and shareholders. Credit risks arising from reinsurers, brokers, agents and clients are not included as "Investment Risks". These categories of credit risk should be dealt with under the analysis of reinsurance coverage and the underwriting process. These risks must be managed but are not the focus of this paper, which deals only with investment risk management.

Definitions

65. Credit risk is the risk of financial loss resulting from default or movement in the credit quality of issuers of securities (in the company's investment portfolio), debtors (for example, mortgagors), or counterparties (for example, on reinsurance contracts, derivative contracts or deposits given) and intermediaries, to whom the company has an exposure. Credit risk includes:

- default risk: risk that an insurer will not receive, or receives delayed, or partially, the cash flows or assets to which it is entitled because a party with which the insurer has a bilateral contract defaults on one or more obligations
- downgrade or migration risk: risk that changes in the probability of a future default by an obligor will adversely affect the present value of the contract with the obligor today
- indirect credit or spread risk: risk due to market perception of increased risk on either a macro or micro basis
- concentration risk: risk of increased exposure to losses due to concentration of investments in a geographical area, economic sector, counterparty, or connected parties.

66. The accepting of credit, in the context of an insurer's claims management, hedging, investment and lending activities, is the provision of funds on agreed terms and conditions to a counterparty (or borrower) who is obliged to repay the amounts owing (often but not always, together with any interest thereon). Credit may be extended, on a secured or unsecured basis, by way of instruments such as reinsurance ceded, premiums for hedging vehicles, mortgages, bonds, asset-backed securities, private placements, leases, and stock lending (from both a quantitative and qualitative perspective), derivatives, and structured products that have the effect of derivatives. Some of these instruments may lead to potential future exposures.

Identification

67. The general areas of credit risk in which an insurer is prepared to engage should be identified in its investment policies. The type of credit activity, type of collateral security or real estate, and types of borrowers on which an insurer may focus should be specified. Special attention should be paid to embedded transactions of credit risk (such as credit derivatives). Furthermore, credit risk of investment activities should be coordinated with credit risk of other

activities of the insurer (i.e. an insurer is exposed to additional counterparty credit risk when dealing with reinsurers and brokers, among others – see the Appendix – Reference 9).

68. Transactions and exposures involving entities that are connected or affiliated to each other require special attention. These transactions and exposures could give rise to non-market terms and conditions, concentration risk or liquidity risks or a combination of them. Therefore, the insurer should have policies on connected exposures, as well as policies on intra-group exposures that ensure:

- connected exposures are viewed at group level and consider potential exposures to all assets and liabilities, as well as reinsurance
- where an insurer is a member of a conglomerate or group, the insurer has policies on its transactions
- with and its exposures to the group.

69. Procedures should be in place for assessing the credit worthiness of counterparties to whom the insurer is exposed and for setting internal limits on such exposures, where appropriate.

70. Procedures should exist which define prudent criteria for identifying and reporting potential problem credit exposures to ensure that they are regularly reviewed, and that provisions are made where necessary. Once these credits have been identified, insurers should prepare a "Watch List" that is monitored by senior management and presented to the board of directors regularly. Insurers should have a disciplined remedial management process, triggered by specific events, which is administered through appropriate credit administration and problem recognition systems.

71. Another instance of credit risk relates to the process of settling financial transactions. If one side of a transaction is settled but the other fails, a loss may be incurred that is equal to the principal amount of the transaction. Even if one party is simply late in settling, the other party may incur a loss relating to a missed investment opportunity. Settlement risk (i.e., the risk that the completion or settlement of a financial transaction will fail to take place as expected) includes elements of market, credit, liquidity, operational risks. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include the timing of the exchange of value, payment and settlement finality, and the role of intermediaries.

72. Insurers engaged in the use of instruments, such as derivatives, should also take into consideration that counterparty exposures could change depending on the mark-to-market value of the underlying financial instrument. Effective measures of potential future exposure are essential for the establishment of meaningful limits, placing an upper bound on the overall scale of activity with, and exposure to, a given counterparty, based on a comparable measure of exposure across an insurer's activities both on and off balance sheet.

73. Insurers should have policies for approval, accepting and monitoring of collateral. This should include assessment of the controls supporting funding exposures, the valuation policies of collateral, including the basis, frequency, discounted assessment and reviews made of the security (see Appendix – Reference 11).

Measurement and management

74. Credit exposure limits should be established within the insurer's investment policies. Measuring compliance with these limits will involve developing the ability to aggregate the insurer's investment exposure within each defined risk classification. These could include exposure limits on the following risk classifications:

- type of collateral security or real estate
- single counterparties and connected counterparties (such as through legal, economic or managerial basis)
- industries or economic sectors
- geographic regions.

75. Rules for the aggregation of individual exposures within a common risk classification, such as conglomerate, industry and geography, should be established and well defined in credit policies.

76. Measurement tools to be used to determine the insurer's credit risk exposure could include:

- internal ratings
- external ratings
- results of stress testing
- concentration aggregations (geography, issuer, group of issuers)
- concentrations within the insurer's group of affiliated companies.

77. Credit risk exposure limits defined by the insurer's investment policies should be expressed in a manner consistent with the risk measures that will be used to monitor the insurer's credit risk activities. Hence, limits and monitoring systems should be determined in conjunction with each other. Measured credit risk exposure will be compared with the limits outlined in the investment policies. For example, the policies may impose a credit limit on the insurer's investing activities defined as:

- a maximum amount or percentage of investment exposure to a single issuer, industry, geographic region, or some other risk classification
- a limit on the amount or percentage of investment exposure to certain levels of credit ratings (external or internal or a combination of these)
- more sophisticated measures may be developed, such as a maximum value at risk, according to the insurer's stress testing capabilities.

78. In order to track portfolio diversification characteristics, insurers should have a system that enables credits to be grouped by characteristics such as type of credit activity, ranking by size of counterparty credit exposures, credit ratings, type of collateral security or real estate, type of borrower, type of industry and geographic regions.

79. The credit risk management function should actively participate in the development, selection, implementation and validation of rating models. It should assume oversight and supervision responsibilities for any models used in the rating process, and ultimate responsibility for the ongoing review and alterations to rating models.

80. Insurers should take into consideration potential changes in financial and economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

81. Although the determination of whether or not a particular concentration (as mentioned in previous paragraphs) is excessive is a matter of judgement, it should satisfy regulatory requirements, be benchmarked against industry norms (if available), and viewed in light of the insurer's capital base and stress test results. In circumstances where an insurer's credit risk has become excessively concentrated, the insurer should take timely steps and have options available to diversify its credit portfolio. This includes assessment on both sides of the balance sheet.

82. The insurer should measure and monitor its risk at both the transaction and portfolio levels to the appropriate time horizon. Insurers should regularly monitor the status of counterparties and underlying security and re-evaluate individual credits, commitments, and their credit ratings. Failure to do so can result in an undetected deterioration of the credit portfolio. Depending on the type of credit and the underlying security, the credit risk management program of each insurer should include procedures governing the regular formal review and, where applicable, the re-rating of credits.

Rating system

83. The term "rating system" comprises all of the methods, processes, controls, data collection and information systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates. Each insurer could articulate in its credit policies the relationship between risk rating grades in terms of the level of risk each grade implies. Perceived and measured risk should increase as credit quality declines from one grade to the next. The policies should articulate the risk of each grade, both in terms of rating criteria associated with the grade, and the approximate range of risk parameters associated with each grade.

84. The structure of an insurer's rating system should be designed in a way that makes certain there is a meaningful distribution of exposures across grades, and a sufficient number of grades to support a meaningful differentiation for lesser grades, including one for borrowers that have defaulted. Insurers with lending activities focused on a particular market segment, such as originating mortgages, will require fewer grades than insurers that lend to borrowers of diverse credit quality.

85. A "rating grade" is defined as an assessment of credit risk on the basis of a specified and distinct set of rating criteria. The grade definition should include both a description of the degree of credit risk typical for credits assigned the grade and the criteria used to distinguish that level of credit risk. Insurers with non-marketable investments, such as loans and private placements, concentrated in a particular market segment and range of credit risk should have enough grades within that range to support meaningful differentiation of risk in respect of the investments held.

86. When assigning ratings insurers should:

- take all relevant information into account
- ensure that such information is current
- verify the integrity of all data used
- be more conservative in circumstances where there is less information available
- ensure that ratings are consistent across the portfolio
- be careful to differentiate between ratings assignment, which is issuer specific, and credit limit setting, which is portfolio based.

87. An external rating may be a primary factor determining an internal rating assignment; however, the insurer should make certain that it considers other relevant information. If an external rating is used, the insurer should address how much reliance it gives to external ratings and how it proposes to keep track of external rating changes.

6. Liquidity risk

88. Liquidity is concerned with the current and future maintenance of appropriate levels of cash and liquid assets, in the context of the demands for liquidity that are imposed by the insurer's asset and liability profile. Under normal business conditions, liquidity risk is limited by the cash flow structure of the insurance business. The business of insurance usually involves the existence of a substantial time lag between the receipt of premium income and payment of expenses and policy benefits. Liquidity stress conditions may materialise primarily due to an unanticipated sequence of policyholders' claims but may sometimes be increased through specific market conditions.

Definitions

89. Liquidity risk is the risk that an insurer, though solvent, has insufficient liquid assets to meet its obligations (such as claims payments and policy redemptions) when they fall due. The liquidity profile of an insurer is a function of both its assets and liabilities.

90. Liquidity risk includes:

- liquidation value risk: the risk that unexpected timing or amounts of needed cash may require the liquidation of assets when market conditions could result in loss of realised value
- affiliated investment risk: the risk that an investment in a member company of the conglomerate or group may be difficult to sell, or that affiliates may create a drain on the financial or operating resources from the insurer
- capital funding risk: the risk that the insurer will not be able to obtain sufficient outside funding, as its assets are illiquid, at the time it needs it (for example, to meet an unanticipated large claim).

Identification

91. The most striking example of loss due to liquidity risk is a “large claim and/or surrender” event (i.e. catastrophes, such as large windstorms or earthquakes). This event may require insurers to pay a large amount of claims within a short period of time. This situation can cause a substantial drain on liquidity, reduce solvency, and may lead the insurer to fail. Some reinsurance contracts include a provision whereby the insurer may be able to receive early claims payments. Such “cash claims” from its reinsurer could be considered as a form of liquidity hedge within the context of liquidity management.

92. There are different levels of liquidity management, including:

- day-to-day cash management
- testing and scenario analysis, including an analysis of catastrophe risk.

93. A single or a few contract holders that control large sums of money (policies or contracts) can expose the insurer to a high degree of liquidity risk. Institutional type products are the biggest risk in this respect, although in retail lines, a small group of agents and/or brokers may control large blocks of business, and that poses a similar risk.

94. The size or credit rating of the insurer, and/ or local regulation, may limit its access to capital markets. If an insurer is too small, it may not have all of the funding choices that are available to larger insurers. Also, when several insurers are faced with a large unpredictable liquidity requirement at the same time and need to liquidate some of their asset portfolio, the marketplace may not be able to absorb the volume other than at unfavourable prices.

95. To the extent that they are predictable, immediate demands on cash should not pose undue liquidity risk for an insurer. Any immediate demand for a cash payment can be a risk if cash is in short supply. A well-managed insurer will structure its assets in such a way so that it has enough cash and marketable securities to cover its known obligations.

96. An unpredictable cash demand is a larger risk. For example, a surrenderable non-life insurance contract may have a 90-day delay provision, which under normal circumstances gives the insurer a reasonable amount of time to access its liquidity sources. The shorter the deferral period, the larger the risk.

97. In jurisdictions that allow borrowing, insufficient ability to borrow short term such as through bank lines of credit or commercial paper increase liquidity risk. For example, following an insurance risk event banks may be unwilling to lend to an insurer. Where possible, formal credit lines should be established to mitigate that risk.

98. Lack of diversity in either the liability or the asset portfolio when analysed by product, geography, industry or creditor can lead to increased liquidity risk. An over-concentration of illiquid assets, such as real estate or thinly traded securities, may be especially risky. Resources should be well diversified, and not over-rely on a single source. This is particularly important for mutual insurers who generally have access to a smaller range of funding sources.

99. Policy redemption options that are sensitive to changes in asset values will increase liquidity risk.

100. Liquidity problems also arise when there is a mismatch between the term of the liabilities and their underlying assets. In these situations, trigger events, such as the insurer receiving a downgrade from a rating agency, can lead to a liquidity crisis. If this is coupled with other factors, such as large policies with flexible surrender terms with short time horizons, the liquidity risk is compounded.

101. Other examples of unexpected strains on liquidity are:

- negative publicity
- reports of problems of other insurers or similar lines of business
- deterioration of the economy
- abnormally volatile or stressed markets.

Measurement and management

102. In order to determine an insurer's exposure to liquidity risk, a set of measurement tools should be selected and then applied to its portfolio. There are no simple formulas that work for all insurers. However, the basic tools that the industry uses can be classified into two groups: cash flow modelling and liquidity ratios. These are tools used to monitor an insurer's liquidity risk profile and should be kept current (modified as the business changes), run periodically and may be used for a business unit or an entire insurer.

103. Cash flow modelling is done to assess the magnitude of deficits, surpluses and the ability of contingent funding to meet the needs of the insurer. It lends itself to a stress testing approach, allowing the insurer to examine its potential liquidity needs under a variety of future scenarios. In this way, the insurer can assess the probability of requiring immediate access to liquidity at a time when this may prove costly (due to forced liquidation of assets at low market values, or high borrowing costs). The insurer can take steps to ensure that it will have sufficient cash and short-term liquid assets on hand to meet unexpected, but not highly unlikely, liquidity requirements.

104. Use of liquidity ratios addresses the need for liquidity by establishing a normal expected amount of liquidity that would be required to meet the demands of the underlying liability portfolio. Taking this as the minimum level of required liquidity and adding an appropriate margin to cover unexpected liquidity requirements will define the required liquidity ratio to be used in the insurer's investment policies.

105. As indicated above, insurers may be able to obtain emergency liquidity funding in the event of a catastrophe by drawing cash early under their reinsurance policies or by other means. This form of liquidity hedging could be recognised when assessing the amount of liquidity available to meet the required level defined by the insurer's investment policies.

106. The insurer should have a liquidity contingency plan to be implemented in the event that its usual liquidity management is unable to meet demands.

7. Supervisory considerations

107. The responsibility for the investment risk management lies with the insurer. The insurer should demonstrate to the supervisor compliance with the guidance outlined in this paper. The application of this guidance should take account of the size, nature and complexity of the business of the insurer. The scope of the application and review should be sensitive to the risk profile of the insurer, together with the supervisor's own regulatory framework.

108. In assessing an insurer's investment risk management function, a supervisor should review the insurer's investment risk management framework, investment policies, and the execution thereof. The supervisor should satisfy itself that an insurer understands the risks it is bearing and has effective procedures for identifying, monitoring and managing its investment activities to ensure that its assets are consistent with its liability profile.

109. Supervisors have to keep in mind the increasing complexity of financial activities and continuous innovations, both in assets or products and in methods or systems. Therefore, supervisors have to be organised in such a way to ensure that supervisory activities are carried out by personnel with a high level of knowledge in financial markets and products. One key step to achieve this goal is to maintain continuous training.

110. The insurer's investment risk management framework should include at a minimum:

- the identification of risks
- the measurement of risks
- control procedures
- reporting procedures.

111. In reviewing the insurer's investment policies, the supervisor should consider whether these:

- are in compliance with regulatory requirements, and contain clearly defined procedures to ensure that regulatory requirements are adhered to
- are protecting the policyholders' rights
- consider operational risks that could arise from investment activities
- are clearly defined with appropriate emphasis on risk management and demonstration of asset liability management
- address the extent of use and management of third parties
- address the use of derivative products or structured products that have the effect of derivatives, in asset classes and insurance products, where applicable
- define the risk-return profile adequately given the product(s) used.

112. Where the investment policy has a direct impact on the returns available to policyholders, the supervisor should satisfy itself that the insurer has procedures in place to monitor that the investment policy is carried out in accordance with the policy conditions or any information provided to the policyholders.

113. Consideration should also be given to whether the insurer's overall investment risk management policies:

- have been developed to appropriately reflect the insurer's risk tolerance given the insurer's financial position
- address how the insurer organises its investment risk management function
- contain clear investment guidelines and procedures to ensure the investment policies are adhered to
- have regard to adequate staff being involved with investment risk issues (at whatever level, such as board level, trading or risk monitoring) who understand the risks involved, are of an appropriate level within the organisation, and have clearly defined responsibilities
- have been approved and are subject to regular review by the board of directors.

114. The supervisor should satisfy itself that the investment risk management functions within the insurer are independent of the investment function.

115. The supervisor should assess whether the insurer is aware of the range of risks that it faces, has procedures in place to identify, monitor and measure these risks and takes steps to manage and mitigate them effectively. The supervisor should conduct regular evaluations of an insurer's policies, procedures and practices related to its investment risks.

116. The supervisor may apply its own tests to the insurer's portfolio to assess whether the measurement of investment risk by the insurer is adequate. Use of benchmarks and tools such as industry norms and stress testing may be useful in this type of exercise.

117. Where the insurer is part of, or heads, a group or conglomerate of companies, the supervisor should assess compliance with the above guidance in a group context.

118. The supervisor may use various means to assess the insurer's investment risk management framework, including:

- required regulatory reporting to capture relevant data (standardised reporting may be considered to enable greater market comparisons)
- external validation and/or use of experts (such as auditors, actuaries, risk managers)
- review of the insurer's systems and controls
- on-site inspections
- off-site surveys and surveillance
- internal audit reports
- review of the insurer's product control
- publicly disclosed reporting
- documentation describing risk management and investment committee framework.

119. The supervisor should satisfy itself that the insurer initiates processes to implement new risk management strategies quickly in response to the emergence of significant new risks or changes in significant risk.

120. The supervisor should satisfy itself that the investment risk management function provides the board of directors, the insurer's management, and any committee(s) involved in investment risk management with timely risk reports in order to take appropriate decisions on risk issues.

121. Deficiencies identified during the supervisory review should be addressed in a timely manner through a range of actions. The supervisor should communicate findings and recommendations to the insurer's management and the board of directors promptly and perform a timely follow up.

8. Information the supervisor may request from the insurer

122. In order to assess the insurer's risk management framework, the supervisor may request, amongst other, the following information:

Documents relating to management of investment risk

- a copy of the insurer's investment risk management policies, including the insurer's tolerance and limits for managing its market, credit and liquidity risks
- a copy of an insurer's asset liability management procedures. For example, the terms of reference of the insurer's asset liability committee, if there is one
- details of the insurer's investment policies, including its identification, monitoring and control procedures, and the terms of reference of the insurer's investment committee, if there is one, including details on the investment guidelines for derivatives or structured products that have the effect of derivatives
- the insurer's procedures for the approval of counterparties, including details on the insurer's procedures for selecting and monitoring external asset managers and brokers used
- details in relation to embedded options
- the insurer's procedures for seeking approval to use new investment instruments and for monitoring the risks associated with these instruments once the insurer commences using them
- a description of the board of directors' overall approach and policies on products, underwriting, reinsurance cover and security, investments and solvency
- details on the employee remuneration structure, to assess whether there are any excessive bonuses or unusual remuneration incentives, which encourage excessive risk taking.

Sample reports

123. Reporting entails costs for insurers and this aspect should be taken into account in setting the reporting requirements. The supervisor may request, amongst others, the following reports:

124. Investment risk management reports:

- reports from the insurer's internal and external audit and risk assessment functions, if applicable, including exception reports, where risk limits and policies have been breached or systems circumvented
- investment risk measurement reports that, at a minimum, cover the following areas:

- details of, and commentary on, investment activities in the period and the relevant period end position
- details of positions by asset type
- concentration analysis of credit exposures by counterparty
- details of any regulatory or internal limits breached in the period and subsequent actions taken, where appropriate
- planned future investment activities.

125. Market risk reports:

- specific details relating to market risks types such as interest rate risk, equity and real estate risk, commodity risk and currency risk
- interest rate risk run by the insurer via a mismatch in the cash flow can be assessed by comparing the expected change in the economic value of assets and the liabilities for changes in interest rates
- the significance of the economic value of derivatives or structured products that have the effect of derivatives like embedded options, with specific attention to asset and/or insurance products that include a guaranteed minimum return
- returns made on the investment portfolio need to be explained. The sources of return can be identified and checked whether the outcome was in line with the mandate. Two types of reporting will provide helpful information:

  1) performance contribution: this concerns the decomposition of total returns and determines what factors have contributed to the return made on the investment portfolio
  2) performance attribution: this concerns the decomposition of excess returns (positive or negative) relative to an assigned benchmark and determines the factors that have caused the relative performance of the investment portfolio.

These reports are to give insight into the development of returns over a single time period (for example, one month) and over multiple periods (for example, one year).

126. Credit risk reports:

- specific details relating to credit risk such as credit exposures, including aggregations of credit exposures, as appropriate, by groups of connected counterparties, and/or by the nature or geographical location of the counterparty
- details of credit decisions, including the facts or circumstances upon which decisions were made
- information relevant to assessing current credit quality.

127. Liquidity risk reports:

- specific details relating to the prospective cash flows of the insurer for both single periods and multiple periods. Expected premium income, liability payments, expenses, payments resulting from lapses of policies, investment income and repayment of principal by debtors as budgeted for that period should allow assessment of the liquidity profile of the insurer under the assumption of a going concern. Stress testing the various flows could give an insight into the liquidity risk under more difficult conditions than assumed

- specific details relating to the level of liquid assets held by the insurer and the terms and conditions of existing credit lines for insurers in jurisdictions that allow borrowing. A way to assess the liquidity of assets is by determining the average number of days required to liquidate that security based on the daily volume of market transactions in that security.

Regular reporting to the supervisor

128. In order to receive current information on investment risk management, the supervisor may wish to establish reporting mechanisms, directly with insurers, including internal audit, and third party (e.g. auditors and actuaries) reports, depending on the regulatory framework.

129. Consideration should be given to the frequency of the data requests. These should be timely, the frequency being determined by factors such as:

- the volatility of the business in which an insurer is engaged (i.e. the speed at which its risks can change)
- any time constraints on when action needs to be taken
- the level of risk that the insurer is exposed to compared to its available financial resources and investment risk tolerance.

Ad hoc requests

130. The supervisor may also request the following information:

- an overall business plan that includes information in respect of the types of business, indicating new products, strategy for distribution, underwriting, investments, reinsurance, a multi year budget and liquidity forecasts. This information should be used to assess whether risk management systems are adequate for the insurer's business
- cost and investment income allocation methods
- financial projections under expected and abnormal (such as stressed) conditions. In addition, reconciliation of actual profit and loss to previous financial projections and an analysis of any significant variances. Scenario testing could be done (for example the percentage change in interest rates and equity values both on the insurer's assets and liabilities)
- details on the insurer's stress testing for economic trends in investment markets
- internal management information on asset portfolios such as:
  - details of the relative position of assets and liabilities
  - details on intra-group investments
- list of matters that required a decision from the board of directors or senior management (such as a significant variation to a business plan, amendments to risk limits or the creation of a new business line)
- when on-site at an insurer, the supervisor could ask how signatories to the insurer's financial returns satisfy themselves that the regulatory financial returns are complete and accurate
- professional qualifications of those entrusted with investment activities and investment risk management
- audit management letters received by the insurer, and the insurer's responses
- details on the insurer's investment function outsourcing, including third party service agreements (if applicable)

- copies of the insurer's compliance reports in relation to investment risk management policies and procedures.

Appendix 1 – References

IAIS References

1. *Glossary of Terms*, September 2003.

2. *Solvency control levels guidance paper*, October 2003.

3. *Stress testing by insurers guidance paper*, October 2003.

4. *Paper on credit risk transfer between insurance, banking and other financial sectors,* presented to the Financial Stability Forum, March 2003.

5. *Principles on capital adequacy and solvency*, January 2002.

6. *Supervisory standard on asset management by insurance companies*, December 1999:

    - chapter 3 provides details on the role and responsibilities of the board of directors and senior managers, and the investment strategy
    - chapter 4 provides details on the risk management function, internal controls and audit.

7. *Supervisory standard on derivatives*, October 1998.

8. *Supervisory standard on supervision of reinsurers*, October 2003.

9. *Supervisory standard on the evaluation of the reinsurance cover*, January 2002.

Other

10. Bank for International Settlements, *Sound Practices for Managing Liquidity in Banking Organisations*, February 2000.

11. The International Organization of Securities Commissions, *Securities lending transactions: Market Development and Implications*, Joint Report by the Technical Committee and the Committee on Payment and Settlement Systems (CPSS), July 1999.

12. International Actuarial Association, *A Global Framework for Insurer Solvency Assessment,* Research report of the Insurer Solvency Assessment Working Party, 2004.

Appendix 2 – New IAIS Glossary of Terms definitions used in this paper

The new definitions and changes to current definitions that are introduced in this guidance paper are as follows:

- **Affiliated investment risk –** the risk that an investment in a member company of the same conglomerate or group may be difficult to sell, lose its value or create a drain on the financial resources of the insurer.
- **Asset liability management –** refers to the management of an insurer's assets with specific reference to the characteristics of its liabilities so as to optimise the balance between risk and return. The insurer's policy with respect to its asset liability management processes will include measures to be used to assess the degree of risk that the insurer is assuming and constraints or boundaries on the value of these measures. Asset liability management will form part of the overall investment risk management framework and will provide direction for investment activities with reference to the demands of the insurer's liability portfolio.
- **Basis risk –** the risk that yields on instruments of varying credit quality, marketability, liquidity and maturity do not move together, thus exposing the insurer to market value variation that is independent of liability values.
- **Blind investments (or pools) –** portfolio of investments managed by an external investment manager. The pool may consist of investments whose general characteristics are known to the pool participants, but the specific holdings are not always known. It may also consist of a pool of capital not yet invested, but with a mandate to be invested by the manager in certain investment vehicles in which the manager has specialised expertise.
- **Capital funding risk –** the risk that the insurer will not be able to obtain sufficient outside funding at the time it needs it (for example, to meet an unanticipated large claim).
- **Commodity risk –** the risk of exposure to losses resulting from movements of market values of commodities, either physical commodities themselves or derivatives that have commodities as the underlying instruments.
- **Complete risk-return profile –** the establishment of a well defined risk tolerance and desired target return that the insurer may wish to achieve in its overall operations or in some specific aspect (for example, product line) of its operations.
- **Concentration risk –** the risk of increased exposure to losses due to concentration of investments in a geographical area, economic sector or individual investments. Concentration risk may exist at either the legal entity level or the group level (after the holdings of all legal entities have been consolidated) or both [Related definitions: *conglomerate risk*, *contagion*, and *risk concentration*].
- **Correlation risk –** the risk of increased exposure to losses due to the level of, or movement in, the correlation of investments in or across geographical areas, economic sectors or individual investments or with and between liabilities.
- **Counterparty credit risk –** the risk that a counterparty is not able or willing to pay amounts owing to the insurer as they fall due.

- **Credit ratings –** assessments of the abilities of debtors (e.g. bond issuers) to pay amounts owing to investors as they fall due. [Related definitions: *credit rating assignment, rating agency, rating grade, rating model, rating process, rating system*]
- **Credit rating assignment –** the credit rating assigned to a particular issuer of debt instruments, or to a specific debt instrument.
- **Credit risk –** the risk of financial loss resulting from default or movements in the credit rating assignment of issuers of securities (in the company's investment portfolio), debtors (e.g. mortgagors), or counterparties (e.g. on reinsurance contracts, derivative contracts or deposits) and intermediaries, to whom the company has an exposure. Credit risk includes default risk, downgrade or mitigation risk, indirect credit or spread risk, concentration risk and correlation risk. Sources of credit risk include investment counterparties, policyholders (through outstanding premiums), reinsurers, and derivative counterparties. [Related definitions: *reinsurance credit risk*]
- **Default risk –** the risk that an insurer will not receive the cash flows or assets to which it is entitled because a party with which the insurer has a bilateral contract defaults on one or more obligations.
- **Downgrade or migration risk –** the risk that changes in the probability of a future default by an obligor will adversely affect the present value of the contract with the obligor today.
- **Equity and real estate risk –** the risk of exposure to losses resulting from movements of market values of and income from equities and real estate.
- **Granularity –** the level of detail that investment policy includes in setting market exposure limits. At a high level, limits may be set with respect to asset class exposure. At a more detailed level, limits regarding specific industries, geographic areas, or even specific issuers may be considered.
- **Hedge –** to invest in a manner that reduces the risk having regard to the underlying assets or liabilities. A hedging strategy will take into account the risks, return required and the projected cash flow of the assets or liabilities, including the existence of policyholder options which may be exercised. Risks to be considered will include market and credit risk.
- **Indirect credit or spread risk –** the risk due to movements in market perception or appetite for risk on either a macro or micro basis.
- **Interest rate risk –** the risk of exposure to losses resulting from movements in interest rates.
- **Internal controls –** the means by which compliance with the insurer's risk management policies is maintained. Regular reporting, including the use of measurements and metrics required to be within limits specified by the risk management policies, may be used to verify compliance.
- **Investment management –** the activity of making and controlling investment decisions [Related definitions: *investment policy, investment risks, investment risk management, investment risk management policy, investment risk management framework, investment risk management function, investment risk exposures, investments risk limits*].
- **Investment policy –** the insurer's policy with respect to the overall characteristics for an investment portfolio or for the investments of the insurer as a whole. A statement of a

portfolio's investment policy will normally include the objectives of the portfolio, its risk tolerance, constraints to be obeyed in the management of the portfolio, such as minimum liquidity requirements, and a list of eligible assets or asset classes in which the portfolio may be invested, along with a target asset mix and limits on how much the portfolio may diverge from the target.

- **Investment risks –** the various kinds of risk which are directly or indirectly associated with the insurers' investment management. They concern the performance, returns, liquidity and structure of an insurer's investments. Such risks can have a substantial impact on the asset side of the balance sheet and the company's overall liquidity, and potentially can lead to the company being over indebted or insolvent.

  The investment risks include:

  - market risk
  - credit risk
  - liquidity risk
  - operational risk

- **Investment risk management –** the process an insurer uses to identify investment risk exposures, and to monitor, measure, report, and mitigate this risk.
- **Investment risk management policy –** the insurer's policy with respect to investment risk management including definition of the investment risk exposures that are present in an insurer's operations, a description of the investment risk management process, and assignment of the investment risk management function within the insurer's structure.
- **Investment risk management framework –** the strategies, policies, procedures, methodology and the organisational structure that an insurer uses to perform its investment risk management function. The investment risk management function is normally separate and distinct from the investment management function, to the extent that this is practical for the insurer.
- **Investment risk management function –** the committees, departments, or persons charged with the responsibility to ensure that the insurer complies with its investment risk management policy and the activities that they carry out, including the oversight of timely corrective action when investment policy constraints are breached and other mitigating action.
- **Investment strategy –** the overall direction by the insurer's investment management governing the insurer's investment policy and investment risk management policy.
- **Investments risk exposures –** measures of the amounts by which an insurer's financial position may vary adversely.
- **Investments risk limits –** the maximum amount of risk exposure that an insurer is prepared to accept. Limits are normally included in the insurer's risk management policy, and monitoring of compliance with these limits is part of the risk management function.
- **Market risk –** the risk to an insurer's financial condition arising from movements in the level or volatility of market prices. Market risk involves the exposure to movements of financial variables such as equity prices, interest rates, exchange rates or commodity prices. It also includes the exposure of derivatives to movements in the price of the

underlying instrument or risk factor. Market risk also involves the exposure to other unanticipated movements in financial variables or to movements in the actual or implied volatility of asset prices and options. Market risk incorporates general market risk (on all investments) and specific market risk (on each investment). [Related definition: *matching risk*]

- **Rating agency –** entity that specialises in assigning credit ratings to borrowers.
- **Rating grade –** an assessment of credit risk satisfying a specified and distinct set of rating criteria. The grade definition should include both a description of the degree of credit risk typical for credits assigned the grade and the criteria used to distinguish that level of credit risk.
- **Rating model –** a systematic approach to determining one or more of the risk characteristics of a potential, or an existing, investment in a consistent manner with other investments to facilitate comparison.
- **Rating process –** the steps used to determine an appropriate rating for a potential or existing investment.
- **Rating system –** comprises all of the principles, methods, processes, controls, data collection and information systems that support the insurer's or credit rating agencies assessment of credit risk, the assignment of risk ratings, and the quantification of default and loss estimates.
- **Risk tolerance –** an insurer's risk tolerance is a statement of the nature and amount of risk exposure that the insurer is willing to accept. The risk tolerance will dictate the risk limits that are established as part of the insurer's risk management policy.
- **Settlement risk –** the risk that the completion or settlement of a financial transaction will fail to take place as expected. It includes elements of market, credit, liquidity and operational risks. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include the timing of the exchange of value, payment and settlement finality, and the role of intermediaries.
- **Value at risk –** A measure of the potential financial loss in the investment portfolio or on the whole balance sheet. Value at risk provides an estimate of the worst expected loss over a certain period of time at a given confidence level. For example, a 12 month value at risk with a 95% confidence level of $1 million means that an insurer would only expect to lose more than $1 million 5% of the time or once in 20 years.
- **Value at risk (VaR) models –** systems which use statistical approaches to determine the value at risk of all or part of an insurer's operations.