IMMEDIATE ATTENTION

SM/01/266

August 21, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Experience with the Insurance Core Principles Assessments Under the Financial Sector Assessment Program**

Attached for the information of the Executive Directors is a paper, prepared jointly by the staffs of the Fund and the World Bank, reviewing the early experience with the assessment of the insurance supervisory core principles issued by the International Association of Insurance Supervisors (the insurance standard-setting body) under the Financial Sector Assessment Program.

It is expected that this paper will be posted on the Fund's external website. If no objections are received by noon on Tuesday, August 28, 2001, the paper will be posted.

Questions may be referred to Mr. Ouanes (ext. 35655) and Mr. U. Das (ext. 36330).

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THE WORLD BANK

Experience with the Insurance Core Principles Assessments Under the Financial Sector Assessment Program

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August 21, 2001

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EXECUTIVE SUMMARY

Assessment of insurance supervisory systems in member countries began in 1999 under the joint Bank-Fund Financial Sector Assessment Program (FSAP). Evaluations are based on the observance of the Insurance Core Principles (ICP) issued by the International Association of Insurance Supervisors (IAIS). The ICP assessments are integrated in Fund surveillance through the *Financial System Stability Assessment* (FSSA) and the *Report on the Observance of Standards and Codes* (ROSCs).

The assessment process is still at an early stage and is constrained by regulatory gaps in several key insurance supervisory areas. Further work is also required on the linkages between macroeconomy and the insurance sector. However, the findings of the 20 ICP assessments completed so far under the FSAP are proving useful in identifying insurance-related supervisory vulnerabilities, as well as development issues such as legal processes, market discipline, and strengthening insurance skills and resources. Weaknesses in meeting the preconditions necessary for effective insurance supervision, divergent accounting, actuarial practices, and the absence of internationally acceptable standards relating to capital have also raised concerns relating to the adequacy of insurance supervisory practices. Transparency practices followed by the insurance supervisors need strengthening to conform to the internationally accepted good practices.

At present, the supervisory deficiencies identified are not posing serious risks to the insurance systems in the countries assessed so far. A number of linkages have been observed which point to the potential for problems relating to the role of insurance and contractual savings in systemic stability. The most common sources of potential systemic vulnerabilities within nonbanks have been equity or guarantee (including credit and mortgage guarantee insurance) exposures to the banking sector. In general, the growth of liberalized and competitive insurance markets is posing new and more complex challenges for the insurance supervisors. The FSAP has been emphasizing the need for approaching insurance supervisory issues in an interdisciplinary way.

While the use of the ICP in the broader context of the FSAP is providing better insights on the overall financial system supervisory vulnerabilities, there are a number of areas in which the assessment process needs to be enhanced. The supervisory principles need further work in terms of clarity and scope. A major gap exists in the degree of specificity in the principles on prudential issues. A more structured approach is also required with respect to assessing the preconditions for effective insurance supervision. The use of the ICP within the FSAP process also needs to be streamlined. These could include: a more thorough pre-FSAP evaluation of the significance of insurance to the financial system, structuring the assessment more specifically to the local environment, and expanding the scope of the assessment, where appropriate, for a more systematic consideration of overlapping insurance, banking, and pension system issues.

The detailed findings of this review will be communicated to the IAIS by the Bank and Fund staff, including suggestions on how the ICP and the assessment methodology can

be improved. Similar feedback will be provided to the *Fund-Bank Financial Sector Liaison Committee* (FSLC) to strengthen the assessment of insurance systems under the FSAP.

I. Introduction

1. **Insurance and the Insurance Core Principles (ICP) developed by the International Association of Insurance Supervisors (IAIS) are, respectively, one of the 11 areas and associated standards recognized by the Bank and Fund Executive Boards as being useful to the operational work of the staff.** The evaluation of insurance supervisory systems in member countries, which began in 1999 during the "pilot" phase of the Financial Sector Assessment Program (FSAP), is based on the degree of observance of the ICP. Twenty ICP assessments have been completed so far under the FSAP while an equal number are under way or planned during FY 2002.

2. **The ICP assessments have become a useful component of the FSAP.** A thorough understanding of the insurance supervision system is assisting in the overall evaluation of the regulatory and supervisory framework of the financial system.[1] Both the Bank and the Fund are devoting greater attention to regulatory and supervisory issues pertaining to the insurance sector. The Bank staff has strengthened its resources in the insurance area and is assisting client countries in developing their insurance systems. The Fund staff has also begun making use of the ICP in its technical assistance work and in the assessment of *Offshore Financial Centers* (OFCs).

3. **This paper analyzes the experience to date with the assessment of the ICP and the main lessons for the future.**[2] It examines the usefulness of the assessments in identifying insurance supervisory vulnerabilities and for the further development of insurance systems. It identifies areas in which the insurance supervisory practices need strengthening and where scope exists for improving international guidance relating to insurance supervision. It also examines the efficacy of the assessment process under the FSAP and suggests ways in which the quality of the assessments can be improved.

4. **The IAIS, which has recognized the Bank-Fund assessments as an instrument for getting feedback on the ICP, has also requested input for the forthcoming re-examination and possible revision of the ICP planned by the IAIS in 2002.** The IAIS and the Bank and Fund staff continue working cooperatively on a number of issues of common concern and this relationship has become particularly important with respect to the implementation of the ICP (see Box 1).

5. **The remainder of the paper is organized as follows:** Section II discusses the development of the insurance sector and the main supervisory approaches; Section III

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[1] The relevance of standards assessments in the context of the FSAP is reviewed in *Financial Sector Assessment Program—A Review: Lessons from the Pilot and Issues Going Forward* (SM/00/263, 11/27/00).

[2] A similar review on the experience with the assessment of the *Basel Core Principles* (SM/00/77, 4/12/00) and the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (SM/00/269, 12/1/00) has been undertaken by the Fund staff.

describes the ICP; Section IV details the assessment process and presents the main findings of the ICP assessments, examines how the evaluation of insurance supervisory practices have been incorporated in the overall financial stability assessments, and analyzes the recommendations typically given by ICP assessors to improve observance; and Section V identifies areas in which the assessment process could be strengthened and where the scope could be expanded to cover gaps in international guidance relating to insurance regulation and supervision.

Box 1. The Bank and Fund Staff and the IAIS

The association of the Bank and Fund staff with the activities of the IAIS was motivated by three factors: (1) the integrated evaluation of financial systems under the FSAP that required appraising insurance supervisory vulnerabilities; (2) the extension of the cooperative and collaborative arrangements with international financial sector standard-setting bodies under the Standards and Codes initiative; and, (3) a better understanding of the international regulatory issues emerging from trends relating to financial convergence between the banking and insurance sectors.

While the initial phase was a less formal one, both the Bank and Fund staff were given Observer Member status of the IAIS in October 2000. Observer status is accorded to organizations, other than insurance regulators/ supervisors, as part of the IAIS' cooperative efforts at working with other relevant international financial entities. These include international organizations, industry associations, insurance companies, insurance brokers, or accounting firms.

A collaborative role has emerged particularly with respect to the implementation of the ICP. The ICP and the assessment Methodology have also been used in the context of the Fund-led assessment of the *Offshore Financial Centers* (OFCs) and in the development of a methodology to enhance the assessment of financial standards relevant for *countering money laundering* under the FSAP and the OFC assessments.

The IAIS is one of the Cooperating Official Institutions under the FSAP and is facilitating the assessment process by identifying practicing insurance experts who can undertake assessments. Further, to assist in monitoring the implementation of the ICP, the IAIS has set up a *Task Force for Monitoring the Implementation of Standards*, with representation from the Bank and Fund staff. The Bank and Fund staff have also been working with the IAIS on issues of common concern, including strengthening and promoting the implementation of the ICP. The Bank is carrying out research on the impact of contractual savings on stability and economic development.

The IAIS is also a member of the Financial Stability Forum (FSF) and the Joint Forum, and works closely with the Basel Committee. At present, the IAIS is made up of insurance supervisors from 150 jurisdictions.

II. Insurance Sector and Supervisory Approaches

A. Insurance Sector Development and Financial Stability

6. **Insurance companies are an important and growing segment of the domestic financial sector in most developed and some developing countries**. In the 1990s, total assets of insurance companies in developed countries grew faster than those of banks. The liberalization of the financial systems underpins this trend, marked by privatization, increased use of contractual savings products, financial consolidation, and full or partial funding of pension systems. In a number of countries, rapid life insurance industry growth is

a result of the convergence of the life insurance and contractual savings sectors.[3] Recent studies[4] show that, while in the early stages of economic development insurance expenditures relative to GDP are low, as per capita income in countries increases, the importance of insurance in the national economy tends to increase rapidly, reaching a saturation point at around the current stage of development of the insurance industry in developed countries.[5] Therefore, one can expect that the importance of the insurance sector in the global financial system is likely to continue to increase.

7. **Resilient, well-regulated insurance systems contribute to financial stability and efficient resource allocation.** Insurance plays a role in supporting economic and financial development as a provider of protection from financial loss due to the occurrence of certain contingent events. This allows investors to enter into commitments that they might not have otherwise been prepared to consider. Accordingly, the insurers' efforts at mitigating risk and to make transfer of risk more affordable and manageable contribute to financial development. In addition, borrowers and issuers of equity have access to a pool of funds that insurance companies are willing to invest for the long term, thus contributing to the development of capital markets.[6] Conversely, in some member countries, the lack of catastrophe insurance can represent an economic vulnerability and impede development through the need to divert public resources after a disaster occurs.

8. **The growing internationalization of insurance and the need for enhanced cross-border supervisory coordination are creating new challenges for the supervisory authorities.** Moreover, some of the recent trends such as demutualization, financial convergence, the role of the insurance industry in the credit derivative markets, and insurance as part of large complex financial groups are also raising new regulatory and supervisory issues. These developments, and the need for better understanding of the implications for the financial system, would require greater attention to systemic stability concerns relating to the insurance sector. The IAIS will have to take an increasing role in order to continue providing guidance in these areas.

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[3] In a number of countries, it is increasingly difficult to separate insurance and privately managed pensions, and the contractual savings sector is large relative to the banking sector.

[4] See Rudolf Enz, "The S-Curve-Shaped Relation Between Per Capita Income and Insurance Penetration," Swiss Re., *Economic Research & Consulting*, Zurich, Switzerland, 2000.

[5] Factors constraining the growth of the *life* insurance sector appear to be high inflation levels and generous government-funded social security arrangements; for *general* insurance, market constraints to growth could include the presence of government monopolies.

[6] See Catalan, M. et al., "Contractual Savings or Stock Markets Development: Which Leads?," *World Bank Research Paper*, August 2000.

9. **Systemic concerns[7] have emerged from the insurance industry, largely because of ownership linkages between the banking and insurance sectors[8] or because insurance sector distress has directly affected the availability of claims payments to key sectors in the real economy** (Table 1). In only a few such instances have the authorities used public funds to assist in the resolution of systemic problems. Except in overly prescriptive jurisdictions, insurers tend to have different strategies or risk characteristics. In particular, the differences in risk characteristics and risk management practices between *life* and *general insurance* can be substantial. The failure of a general insurance company, for instance, could interrupt certain services because of the loss of insurance protection for users of these services.

B. Insurance Regulation and Supervision

10. **In many countries, including some industrial countries, effective insurance prudential regulation for the insurance industry has emerged only in the last two decades.** In the past, some insurance supervisory approaches were based on the control of insurance products, pricing, and policy conditions as the basis for calculating the value of policyholder liabilities. Other supervisors used techniques based on solvency monitoring. During the 1990s, several supervisory authorities have increasingly adopted a market-based solvency monitoring approach, which appears to be gradually gaining universal acceptance.

11. **Insurance supervisors began working together at the broad international level less than a decade ago and are primarily concerned with policyholder protection rather than systemic risk or development issues.** This approach has strongly influenced the development of the internationally recognized regulatory principles. The underlying philosophy of modern insurance supervision is to identify problem companies early, act promptly, and apply effective intervention. This requires solvency margins, which are large enough to provide the time needed to resolve problems so that policyholder benefits are protected. Discussions are under way to set explicit international guidance on capital requirements (see Box 2).

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[7] For the purpose of this review, systemic concerns relating to insurance could arise in situations which lead the authorities to use public funds to manage private sector insurance insolvency, or exercise management control to maintain or support the contractual rights of policyholders.

[8] A common and increasingly important linkage occurs when insurers underwrite credit risk on behalf of credit-granting institutions. Occasionally, a credit-granting system can become exposed to a small number of insurers.

Table 1. Examples of Systemic Events Arising from Insurer Failure

Country (Insurer)	Year	Nature of Crisis
Ireland (Insurance Corporation of Ireland–general)	1985	The Insurance Corporation of Ireland (ICI) came close to formal liquidation because of poor underwriting in its London branch and under reserving. Its parent at the time was Allied Irish Banks (AIB) and the failure of a major subsidiary could have caused a run. The Irish government purchased the company from the AIB and appointed an administrator.
Australia (HIH Insurance–general)	2001	HIH Insurance was the major liability (including social insurance) underwriter in Australia. It collapsed in early 2001 and an administrator was appointed. HIH Insurance was the major insurer of builders' liability in the country and the supply of credit to the construction industry stopped almost immediately, threatening economic growth and mortgage lenders' security. State and federal governments had to intervene, using different mechanisms, to ensure that the building sector could continue operating.
Korea (Insurance savings products)	1998–2001	Korean life and general insurers were encouraged to sell short-term savings products, some of which had deposit characteristics. Competition from banks and trust companies led to an interest rate war at a time of neutral or negative cash flows and massive deficits began to emerge. To prevent a run, the government guaranteed insurance liabilities. Much of the industry has since had to be wound up, or recapitalized by the government and sold.
Jamaica (Life insurance sector–savings products)	1996	The Jamaican life insurance industry had significant equity and fund flow cross-linkages with the banking sector, and was in some cases selling deposit equivalents as well as taking on major property exposures. A weak banking sector thus became exposed to an insolvent insurance industry and a rare case of insurance/banking contagion emerged. The government set up an asset management company, which has issued paper to fill balance sheet gaps.

12. **While the insurance industry is changing in response to the demand for new products and services, the management and control of the insurers have not necessarily evolved as rapidly**. As a result, there continues to be a wide range of practices in use for measuring and managing the risks in *life* and *general* insurance. In addition, there is continuing discussion between the industry and the supervisors about how the recent changes should translate into new practices and standards within the industry.[9]

[9] These include practices to value liabilities that arise under new types of products, and the accounting treatment for financial guarantees and financial reinsurance arrangements.

Box 2. Capital, Accounting, and Actuarial Practices

At present, there is no equivalent to the Basel Capital Accord in the insurance sector. This is mainly due to the complexity in developing common standards that deal with the variety of insurance liabilities and asset combinations available. Accounting standards for insurance firms can vary markedly both in terms of the treatment of accruals and the rigor between (and within) countries. In addition, there is as yet no international actuarial standard for valuing policyholder-related liabilities, which is the single most important item in an insurer's balance sheet.

The differences in accounting and actuarial practices constitute a fundamental challenge for the work necessary to harmonize financial reporting standards that recognize the unique features of insurance, while meeting the needs of capital market participants and insurance supervisors alike. Insurance differs from banking in that the major liabilities do not emerge from a deposit or debt ledger; instead, they have to be estimated using actuarial or other techniques.

Actuaries have developed measurement techniques to value policyholders and other liabilities. However, more work needs to be done to establish common international standards and to ensure that all aspects of the insurance business are covered. This work has to recognize the diverse nature of the insurance products and services that are offered. In some general insurance cases, the uncertainty attached to the liabilities can be considerably greater than that arising from the assets side of the balance sheet.*

The IAIS has issued draft general principles for consultation with its members on Capital Adequacy and Solvency (expected to be adopted in September 2001). However, these still do not specify qualitative requirements. They do recognize that the issue is complex and requires harmonization of international accounting, actuarial, and capital standards.

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* General insurance usually involves a contract covering one year of risk; however, claims may take many years to settle and can involve expensive litigation. Life insurance usually covers multiple years of usually more predictable risk (other than market risk) and has an ongoing premium stream.

13. **Reinsurance is a significant part of both life and general insurance.** An important aspect of general insurance is the extent and the global nature of reinsurance. At best, reinsurance is only lightly regulated in most countries but represents one of the major assets on the balance sheets of many general insurers.[10] The global general insurance industry remains heavily exposed to a small number of internationally active reinsurance companies based in Bermuda, Germany, Japan, Switzerland, United Kingdom, and the United States. Most have traditionally maintained very conservative accounts. However, capital market pressures for more 'efficient' use of capital, including a growing demand for transparency, tends to reduce capital ratios within these companies which could be having a negative effect on the overall security of the insurance sector.

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[10] Reinsurance is effectively contingent capital (a form of call option) and most nonlife insurers make heavy use of this financial instrument to manage risk exposure or to satisfy solvency requirements.

14. **The regulation of these institutions remains a controversial issue among insurance supervisors and the IAIS is working to develop standards in this area by 2002.** While there is an agreement that the reinsurance arrangements that direct-writing companies have in place should be subject to supervision, there is disagreement on the extent to which the reinsurance companies should be supervised. However, even in countries where reinsurance firms are actively supervised, the focus is on contractual and prudential issues and the industry generally deals with the market conduct aspects of reinsurance.

III. IAIS AND THE ICP

15. **The IAIS was established in 1994, some two decades after its banking and securities equivalents, and became a standard-setting body in 1996.** The latest version of the ICP and the Insurance Core Principles Assessment Methodology (Methodology) was adopted by the IAIS members in October 2000.

16. **The ICP provides a framework of 17 supervisory principles that need to be in place for effective insurance supervision.** The IAIS regards these principles as essential supervisory and regulatory principles that all countries should implement. These include: governance issues, prudential requirements, information exchange, and sanctions (see Appendix I). A number of supporting documents (IAIS standards) have also been subsequently developed (licensing, on-site inspections, and derivatives), and new standards continue to be developed (reinsurance, solvency margin requirements).

17. **The ICP Methodology strengthens the framework established by the ICP document in several ways.** It provides an explanation of each principle in terms of its purpose and the elements that need to be reflected in the implementation. It prescribes a scheme for assessing the effectiveness of the insurance supervisory regime by prescribing over 200 assessments "criteria" comprising elements based on sound supervisory and regulatory practices. The IAIS also has recognized that assessments initiated by the Bank and the Fund "provided an opportunity to test both the applicability, clarity, and completeness of the ICP, as well as the degree to which an outside assessor could form an opinion regarding observance of the principles."

IV. ICP ASSESSMENT PROCESS AND FINDINGS

A. Assessment Process

18. **The assessment of the insurance supervisory system under the FSAP aims at: (1) identifying gaps in insurance sector regulation and supervisory practices; and (2) providing input for the overall stability assessment of the financial system.** The main instrument used to achieve these objectives is an assessment of ICP observance (the ICP was issued by the IAIS in 1997 and revised in 2000). This is combined with the risk analysis of the broader financial system to establish vulnerabilities of the insurance sector.

19. **Of the 20 ICP assessments completed so far under the FSAP, three of the early assessments were done using the 1997 version of the IAIS insurance supervisory**

principles, while the rest were based on the expanded version of these principles published in 2000 (Table 2). Thirteen ICP assessments have used the Methodology as a tool in the assessment, whereas the other seven were completed prior to its development. The countries assessed included five advanced, seven developing, and eight transitional countries; the insurance sectors in these countries are at various stages of development. While the small size of the sample precludes the drawing of any definitive conclusions, useful observations have been possible on the insurance supervisory vulnerabilities, their potential impact on financial stability, and in identifying development needs of the insurance system.

20. **A range of tools was used in undertaking the assessments, the most important being the Methodology**. The Methodology requires an assessment of supervisory processes not to be done in isolation, but after taking into account the risks and vulnerabilities from macroeconomic developments facing the insurance sector. Active use is also made of any self-assessments done by supervisory authorities prior to the FSAP, relevant laws and regulations, interviews and discussions with supervisory authorities, other domestic regulatory bodies, groupings of actuaries, accountants, and auditors, and licensed insurance firms. To establish cross-sectoral linkages and form a view on overlapping issues, the assessors also discuss their findings with the banking and securities regulators.

21. **Thus far, assessments have mainly involved staff from the Bank, supported by the Fund staff**. Assessors have also been drawn from the Cooperating Official Institutions and, in some cases, after consultation with the IAIS. All assessments have mainly been carried out by at least one experienced insurance supervisor. However, in the recent period, use is being made of two assessors where so dictated by country-specific factors such as the size of the insurance sector, the presence of complex financial institutions, or where development needs are great.

22. **The assessors have adapted the application of the ICP to the stage of development of the insurance system**. They have recognized that supervisory processes in different countries often reflect the local culture and attitude toward insurance, as well as the national authorities' ability to rely on the work of insurance accountants, auditors, and actuaries. In some cases, therefore, the assessors have modified the minimum set by the Methodology and assessed the country against the standard that the assessor felt the country should achieve. In many cases, they interpreted the ICP in slightly different ways, especially while assessing the principles relating to *Changes in Control, Liabilities, Sanctions, and Cross-Border Business*. This assessment calibration appears necessary given the differences in the systemic significance of the insurance system. Differing interpretations should, however, get minimized as the IAIS progressively sets supervisory standards underlying the ICP.

23. **Assessors are strengthening the macroprudential analysis underlying the supervisory framework**. Recent assessments have begun making systematic use of insurance-related financial soundness indicators to assist in the analysis of the insurance supervisory vulnerabilities. These include: ratio of the liabilities of life insurance companies to total bank deposits; ratio of the government bonds held by the insurance industry to the outstanding domestic debt; and ratio of total insurance premiums to GDP.

Table 2. FSAP: Countries with Completed Assessments of Observance of ICP (April 2001)

Country	Month 1/	ICP Assessment Done Without the Use of IAIS Methodology 2/	Completed and Disclosed IAIS ICP Self-Assessment	Insurance Penetration, 3/ 1999		Total Assets to GDP, 1999 (Percent)
				World Quartile 4/	(Percent)	
Armenia	Sep-00			4	1.1 5/	0.2
Cameroon	Feb-00	X		4	0.9 5/	1.7
Canada	Oct-99	X	X	1	6.5	33.5
Czech Republic	Nov-00			2	3.4	8.2
Dominican Republic	Jan-01			3	1.9	2.1
Estonia	Feb-00	X	X	3	1.7 6/	2.1
Finland	Apr-01		X	1	8.9	22
Ghana	Jul-00			4	0.9 6/	1.8
Hungary	Feb-00	X		3	2.6	4.8
Iceland	Nov-00		X	3	2.5	10.2
Ireland	Feb-00	X	X	1	9.8	44.8 6/
Israel	Sep-00			1	6.1	n.a.
Kazakhstan	Feb-00	X		4	0.3 6/	n.a.
Latvia	Feb-01		X	3	2.4	3.1
Mexico	Mar-01		X	3	1.7	2.3
Poland	Sep-00		X	2	2.9	4.7
Senegal	Nov-00			4	1.1	3.9
Slovenia	Nov-00		X	2	3.7	6.1
South Africa	Oct-99	X	X	1	16.5	80 6/
Tunisia	Feb-01			3	1.6	4.8
Memorandum items						
World average 4/	...	...	...	...	4.1 7/	n.a.
Sample average	...	...	...	...	3.8	13.1

Sources: Financial System Stability Assessment (FSSA) reports; Swiss Re., "Sigma," No. 9/2000; and staff estimates.

1/ Date of first mission in the country. Most FSAPs were organized in two missions.
2/ IAIS Methodology was adopted in October 2000, but FSAP assessors have used drafts of the Methodology in ICP assessments since May 2000.
3/ Percentage ratio of total insurance premiums (life and general) to GDP.
4/ Based on Swiss Re. data for 76 countries.
5/ 1997 data.
6/ 1998 data.
7/ Unweighted average.

B. Assessment of Preconditions

24. **The Methodology identifies a set of preconditions for effective insurance supervision**. These include: a sound legal and accounting system; procedures for resolving problems in insurance companies; effective market discipline; and sound and sustainable macroeconomic policies. There is, however, no explicit supervisory principle in the ICP document relating to the overall framework of insurance supervision.

25. **Noting, however, that shortcomings in the overall conditions of insurance supervision may significantly impair the ability of the insurance supervisor to implement the principles, the Methodology requires assessors to evaluate the degree to which the identified preconditions are met and indicate potential problems stemming from any shortcomings**. The Methodology, however, does not prescribe a basis to evaluate these preconditions. This remains a major limitation of the ICP and the Methodology, particularly as these preconditions cover issues that are generally outside of the control of the supervisor (operational independence, political interference, legal protection for supervisors). Future assessments should consider actions that supervisors can take to mitigate the effect of the preconditions that are not fully satisfied.

26. **Assessments of the preconditions for effective insurance supervision reveal that some countries partially met the preconditions for effective insurance supervision, with qualifications related to the fact that while good laws were either in the process of being adopted or recently passed, they have not been tested in practice, or that the familiarity with the laws was weak**. In some countries, assessors concluded that the judiciary system was weak, laws were outdated, and there were few qualified professionals (i.e., actuaries, accountants, auditors, and financial analysts). In a few cases, while the laws were outdated, the judiciary system was found to be satisfactory and some qualified professionals were present.

C. Assessment of the ICP

Main findings

27. **Supervisory areas in which country practices were assessed to be generally satisfactory with respect to the ICP are: *Financial Reporting; Cross-Border Business Operations; Capital Adequacy and Solvency; Sanctions; Prudential Rules—Liabilities; and, Confidentiality***. The most commonly identified strengths were:

- *Financial Reporting:* Financial reporting requirements are set within the country and companies were required to file financial reports with the supervisory authority at least quarterly; audited financial reports were required annually.

- *Cross-Border Business Operations:* All foreign companies are required to be licensed to sell insurance in the country.

- *Capital Adequacy and Solvency:* Supervisory authority is able to prescribe capital and solvency standards that companies are required to meet.

- *Sanctions:* Many supervisory authorities have broad powers and a wide range of sanctions ranging from fines to licensing restrictions and de-licensing. Supervisors, however, often have limited discretionary powers and can only apply sanctions in the event that the company violates the law.

- *Prudential Rules—Liabilities:* Supervisory authorities can set the basis for the valuation of liabilities. This is done either directly by the supervisory authority, through another branch of government, or through a domestic actuarial standard-setting body.

- *Confidentiality:* Staff of the supervisory authority is subject to professional secrecy requirements, and required to maintain the confidentiality of supervisory information.

28. **It may be noted though that the satisfactory assessment of the supervisory practices relating to *liabilities* was mainly due to the fairly accommodating wording of the ICP**. The formulation is broad enough to capture a wide range of established practices. To observe the principle, a supervisory authority must have powers to set the method and basis for the valuation of policy and other liabilities. However, the principle does not require that the authority be applied to any particular prudential standard. This is an important area that requires more work.

29. **Areas in which supervisory practices were identified as weak include: *Organization of an Insurance Supervisor; Changes in Control; Corporate Governance; Internal Controls; Prudential Rules—Assets; Reinsurance; Market Conduct;* and *Derivatives and Off-Balance Sheet Items* (Table 3).** The most frequently cited shortcomings in the implementation of the principles in these supervisory areas were:

- *Organization of an Insurance Supervisor:* Weak institutional capacity characterized by inadequate supervisory skills and staff numbers, lack of financial resources and operational independence, and a nontransparent accountability framework.

- *Changes in Control:* The supervisor is often notified in advance but: there are no clear criteria for denying a change in control; supervisory approval is not required; or the supervisor has no authority to deny a change in control. In some cases, the supervisor is not notified in advance of a change in control.

- *Corporate Governance* and *Internal Controls:* Lack of a description of the role and responsibilities of the board of directors of insurance companies in relevant legislation and regulations; and supervisors do not have the authority to define the role of directors. The most commonly identified reasons for non-observance or less than full observance of the principle on internal controls were the need to establish or strengthen risk management, asset-liability matching, and the supervisors' lack of authority to enforce an internal control regime in companies.

Table 3. ICP Assessments: Percentage Shares of Observance with the ICP

Core Principle (CP)	Number of Countries in Which CP Was:			Distribution of Assessment Grades 1/			
	Not Assessed	Not Applicable	Applicable and Assessed	Observed	Largely Observed	Materially Non-Observed	Not Observed
CP 1. Organization of an Insurance Supervisor	3	0	17	17.6	52.9	23.5	5.9
CP 2. Licensing	0	0	20	40	50	5	5
CP 3. Changes in Control	0	0	20	60	5	15	20
CP 4. Corporate Governance	0	0	20	25	5	30	40
CP 5. Internal Controls	0	0	20	20	25	30	25
CP 6. Prudential Rules—Assets	0	0	20	30	20	40	10
CP 7. Prudential Rules—Liabilities	0	0	20	50	35	15	0
CP 8. Capital Adequacy and Solvency	0	0	20	65	20	5	10
CP 9. Derivatives and 'Off-Balance Sheet' Items	0	4	16	25	31.3	25	18.8
CP 10. Reinsurance	1	0	19	42.1	26.3	5.3	26.3
CP 11. Market Conduct	3	0	17	41.2	11.8	41.2	5.9
CP 12. Financial Reporting	0	0	20	70	25	5	0
CP 13. On-Site Inspection	0	0	20	35	50	5	10
CP 14. Sanctions	0	0	20	50	35	10	5
CP 15. Cross-Border Business Operations	5	7	8	75	0	25	0
CP 16. Coordination and Cooperation	1	0	19	47.4	31.6	10.5	10.5
CP 17. Confidentiality	0	0	20	60	35	5	0

Sources: Detailed assessments of observance of ICP from FSAP reports and staff estimates.

1/ In percentage of the number of countries in which the CP was found to be applicable and was assessed.

- *Prudential Rules—Assets:* Need to strengthen the investment rules and exposure limits for assets. In a few cases, the concern was that the investment rules were too limiting for reinsurance companies, which constrained the development of the market.

- *Reinsurance:* In all but one case, the identified shortcomings relate to the inadequacy of the supervisors' power to review or set standards for the use of reinsurance by direct-writing companies. In some instances, the assessor was also concerned that the supervisory authority needed greater power in setting retention limits (that is, a limit on the insurance risks that the direct-writing company would keep before seeking reinsurance protection).

- *Derivatives and 'Off-Balance Sheet' Items:* Need to define or strengthen the rules for the use of derivatives and the disclosures made by insurance companies in respect of their use of these instruments.

- *Market Conduct:* Need to ensure that insurance companies establish a complaint-handling system and supervisors need to have their role clarified and strengthened in this area.

Stage of development of insurance sector

30. **The stage of development of the insurance sector in the countries that were assessed varied substantially**. Shortcomings in the observance of ICP in countries in which insurance plays a bigger role in the financial system can have a far greater impact on financial stability than in countries in which it is underdeveloped. Furthermore, supervisors in these two groups of countries face quite different challenges in exercising their responsibilities.

31. **To gauge the impact of the stage of development of the insurance sector on ICP assessment findings, countries were grouped according to their relative standing on insurance penetration.** Insurance penetration is used as a proxy for the stage of development of the insurance industry in a country relative to the global trends in the insurance business.

32. **The results indicate that the degree of observance of ICP in countries with the most developed insurance sectors was significantly higher than that in countries with least developed insurance sectors.** The degree of observance of ICP in countries in different intermediate stages of development of the insurance industry is quite similar, but significantly lower than that of countries with the more developed insurance sectors. The incidence of non-observance of ICP in the areas of *Corporate Governance, Prudential Rules—Assets, Reinsurance, Internal Controls, Derivative*s and *'Off-Balance Sheet' Items, Market Conduct,* and *Changes in Control* in countries that fall in the fourth quartile of the world distribution of insurance penetration was much more frequent than in countries with more developed insurance sectors.

Use of the Methodology

33. **The use of the Methodology from May 2000 as the main tool for conducting the ICP assessments has had a significant impact on the assessment process.** Comparison of the distribution of assessment grades in ICP assessments conducted with and without the use of the Methodology shows that its adoption has resulted in a more systematic approach and uniformity in the assessment of the countries' supervisory practices. The major benefit from the Methodology has occurred in determining supervisory vulnerabilities relating to *Licensing, Corporate Governance, Organization of an Insurance Supervisor, and Capital Adequacy and Solvency.*

Observance of ICP and transparency practices of insurance supervisors

34. **In conjunction with the ICP assessment, assessments are also being made of the transparency practices of the insurance supervisor. The assessment is undertaken with reference to the *IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code).*** [11] A high degree of observance of ICP is

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[11] The IAIS was a member of the Consultative Group on the *Supporting Document* to the *Code of Good Practices on Transparency in Monetary and Financial Polices.* The IAIS
(continued)

associated with the high degree of observance of the *MFP Transparency Code* in the area of insurance and supervision and vice-versa.

35. **Transparency practices of insurance supervisors are strongest in the area of public availability of information on financial policies, whereas transparency practices related to assurances of integrity of the insurance supervisor are most deficient.** The most commonly identified shortcomings include: internal governance procedures are not publicly disclosed; cooperation and information-sharing agreements with other supervisory agencies are not transparent; publication of audited financial statements of the insurance supervisor is not done on a preannounced schedule; some of the procedures for appointment, terms of office, and removal of insurance supervisory officials are not publicly disclosed.

ICP assessments and the IAIS self-assessments

36. **The IAIS initiated a self-assessment program based on the Methodology in October 2000.**[12] By the end of May 2001, nearly 61 percent of the members had responded. Ten of the twenty countries that underwent ICP assessment under the FSAP agreed to have the IAIS share their self-assessments with the Bank and the Fund. The analysis of the differences in the assessment of observance of ICP between the ICP assessments and the IAIS self-assessments highlights some interesting patterns of how insurance supervisors assess their performance relative to peer assessments.[13]

37. **On average, five of the seventeen core principles were assessed differently between the ICP assessments and the IAIS self-assessments.** In about 60 percent of the cases in which differences arose, countries assessed their insurance supervisory practices higher than the FSAP assessor, while in the rest the opposite was true. Four countries contributed disproportionally to the total number of differences in assessments. ICP assessments under the FSAP carried out in the absence of the use of the Methodology tended to assess countries' supervisory practices more flexibly in almost all areas. A possible explanation for the relatively large number of cases, in which countries assessed their observance of core principles more conservatively than the FSAP assessors, is that all IAIS self-assessments were based on the Methodology, whereas some ICP assessments were not. Supervisory areas, in which countries' practices were most often assessed better in the

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Methodology lists the Code as one of the key standards that should be reviewed wherever relevant while assessing observance of the ICP.

[12] The IAIS had conducted a self-assessment exercise in 1998. However, in the absence of an assessment methodology and a proper dissemination of the supervisory principles, the self-assessments could not provide meaningful information on the prevailing insurance supervisory practices.

[13] In interpreting the results, it should be kept in mind that all ten self-assessments were done in the period January–April 2001, during or up to eighteen months after the completion of the respective ICP assessments under the FSAP.

self-assessments were: *Licensing; Prudential Rules—Assets; On-Site Inspection;* and *Sanctions*. Conversely, country practices in the areas of *Derivatives and 'Off-Balance Sheet' Items; Reinsurance;* and *Corporate Governance* were most often assessed more conservatively in the IAIS self-assessments.

38. **Overall, compared to the ICP assessments, the IAIS self-assessments have tended to focus more on formal observance with legislation and regulations and less on shortcomings in the enforcement of the existing supervisory framework.** The emphasis is primarily from the point of view of the insurance supervisor rather than the insurance system as a whole so as to bring out issues relating to the operational independence of the insurance supervisor, or the extent of political interference that may be hampering the objectivity of insurance supervision. Another important aspect relates to the emphasis given under the FSAP in evaluating the supervisory regime within the context of the industry structure and the extent to which observance is adequate to address the emerging risks in the financial system.

Implications for financial sector vulnerabilities

39. **The ICP assessments are being used by the Fund staff as input into the stability assessments and by the Bank staff in the assessment of the overall development needs of the financial system.** The assessment findings reveal several potential sources of supervisory risks and vulnerabilities. Two issues affecting stability have emerged. First, several assessments noted the stability risks emanating from weakness in the supervisory coordination among insurance, banking, and securities supervisors. While this was mainly in the case of countries where financial conglomerates exist or are gaining importance, the findings have a general application. The insurance supervisor needs to monitor, along with other sector supervisors, the systems for risk identification and risk management across financial groups. A second area relates to strengthening the regulations relating to the prudential framework and its enforcement. These relate particularly to liabilities, where weak supervisory practices and requirements could conceal institutional weakness. In several cases, the ICP assessments cited the interconnectedness of financial institutions (insurance companies and banks) as having the potential to lead to a systemic problem. In one case, the issue highlighted was the failure of the supervisor to sign MOUs with foreign supervisors, given that most of the insurance companies were owned by foreign companies.

40. **In a few cases, the assessments did not raise any stability-related concerns despite the countries' low level of observance of the ICP. This was due to the small size of the insurance sector relative to the other constituents of the financial system.** In a few instances, the framework provided by the ICP was found inadequate in assessing the financial system, which was characterized by financial conglomerates and complex financial structures. In some cases, it became clear that the supervisory authority was not yet ready for a full ICP assessment under the FSAP and that a more comprehensive assessment of the preconditions of insurance supervision would have been more effective.

V. ICP Assessment Recommendations

41. **Each ICP assessment identifies areas in which the supervisory authority should make changes to strengthen insurance supervision.** ICP assessment recommendations have two objectives: (1) to strengthen supervisory practices where weaknesses are identified; and (2) raise the quality of insurance supervision in areas where, even though countries met the requirements of the ICP, additional steps could further foster the development of a sound insurance sector. An analysis of the supervisory areas where recommendations were most frequently made was undertaken by groups of countries based on the stage of development of their insurance sectors. The patterns in the clustering of recommendations by broad areas of supervision support the view that assessors have addressed both objectives of this part of the assessment process. There is a clustering of recommendations in supervisory areas that were identified as weak in a significant number of countries (see Section IV.C).

42. **Several recommendations were also made to strengthen the preconditions.** These included the need to strengthen the legal infrastructure, supervisory resources, accounting, and disclosure practices. In addition, recommendations were also made in areas where observance of the ICP was assessed to be satisfactory but scope existed for further development. While some of these recommendations address shortcomings in observance of the ICP, others attempt to raise the quality of insurance supervision above the prescribed minimum. The most commonly made recommendations related to *Organization of an Insurance Supervisor, Licensing, Prudential Rules, and Corporate Governance*:

- *Organization of an Insurance Supervisor*: Increase the number of staff in the authority; improve the quality of staff (training and recruiting) and the supervisory framework; enhance the independence of the supervisor; strengthen indemnity of the supervisory staff.

- *Licensing:* Increase the supervisor's authority and role; strengthen licensing criteria; tighten up the rules on composite companies; set rules for changes in control to be similar to licensing requirements.

- *Prudential Rules:* Strengthen investment rules and limits; upgrade rules for valuation of liabilities; strengthen capital requirements; define rules for the use and disclosure of derivatives; enhance supervision of reinsurance arrangements.

- *Corporate Governance:* Clarify or define what is expected of boards of directors; establish risk management practices.

VI. Follow-Up on the ICP Assessments

A. National Authorities' Views on ICP Assessments

43. **The degree to which the assessment process has the support from each country and the extent to which the national authorities are willing to take corrective action is an important part of the FSAP process.** Feedback from national authorities shows that the

assessment process was found to be useful in the implementation of the ICP. The assessments have provided impetus and direction to national authorities' ongoing efforts to bring their insurance legislation and regulatory framework in observance with internationally accepted supervisory practices. Several countries report difficulties in the implementation of the principle relating to Corporate Governance. This is mainly due to the lack of development in the local standards of general business practice or legislation. The "Fit and Proper" test and "Coordination and Cooperation with Other Supervisors" are also mentioned as being difficult to implement by a number of countries. In addition, some countries reported resistance on the part of the insurance industry to changes in regulations introduced as a consequence of the recommendations based on the ICP assessment.

B. Technical Assistance

44. **Usually, the assessments list recommended actions that should be assigned priority from the perspective of addressing short-term vulnerabilities or reform required to strengthen the overall supervisory framework.** These have provided a good basis for independent follow-up by the supervisory authority or by requesting follow-up technical assistance from the Bank and the Fund. In several cases, the countries have reported that the recommendations helped them to formulate their own policy priorities. In three of the twenty cases assessed so far, follow-up technical assistance has been provided. These have been in the areas of insurance legislation, regulation, and organization of the insurance supervisory body.

45. **The Bank and Fund staff have also received from the IAIS a request for technical assistance identified by the supervisory authorities as follow-up to the IAIS self-assessments completed recently.** These have been in the areas of insurance legislation, setting up the insurance supervisory agency, corporate governance, and prudential regulations. The Bank and Fund staff are in dialogue with the IAIS on the scope and modalities of such technical assistance and ways in which it can be integrated with the pre- and post-FSAP work.

VII. Concluding Observations

46. **The FSAP provides the ICP assessments a useful context for assessing stability and development needs of the insurance system.** The macroeconomic and financial vulnerabilities, coupled with a complete assessment of the bank and securities market supervision, allow the insurance sector findings to be placed in perspective. Some further analytical work is, however, required with respect to how insurance enhances financial system efficiency and affects financial stability. Further, while the Methodology should remain the main tool for assessing insurance supervisory systems, the assessors need to supplement it with other IAIS standards and guidance while evaluating risks and vulnerabilities specific to individual jurisdictions. This is especially important while conducting assessments in more complex insurance markets, given the gaps and the need for further improvements in the ICP and the Methodology.

A. Preconditions Assessment

47. **Assessment of the preconditions is a critical element of the assessment process.** However, the criteria for assessing the preconditions for effective insurance supervision need urgent attention. The assessment experience reveals that in cases where significant shortcomings in the preconditions for effective insurance supervision are identified, the focus of the FSAP review could be better directed at reviewing ways to strengthen observance with the preconditions. This would assist the assessment process in focusing in on the key issues that would strengthen the insurance supervisory system.

B. Areas for Improving the ICP and the Methodology

48. **The use of the ICP as a tool in the FSAP needs to be enhanced in several areas.** While the ICP sets out the powers and responsibilities that insurance supervisors should have, they do not specifically require that supervisors implement and use these supervisory powers. Some of the principles cover a broad topic while others deal with a narrow issue. The principles dealing with prudential issues (assets, liabilities, capital and solvency, and reinsurance) need to be developed further. Three broad areas in which the IAIS could therefore initiate work to improve the ICP are: increase the scope of the ICP (market conduct); improve the clarity of the ICP (organization, licensing, cross-border operations); and remove overlapping criteria (confidentiality). Critical to the success in developing and defining sound international standards in these areas is the work that is under way with the International Accounting Standards Board and the International Actuarial Association. As such, these standard-setting bodies should be encouraged to continue to place importance to their work in setting international standards for insurance enterprises.

C. Linkages to Stability

49. **In considering the assessment findings and the relationship between the observance with the ICP and financial stability,** it became clear that more experience and a well-defined macroprudential framework relevant for the insurance sector is necessary in order to make a determination of the important linkages. However, the assessments clearly show that the risks to insurance stability is greater in situations in which the preconditions for effective insurance supervision are not fully met and there is less than full observance with the prudential principles. This, together with a high insurance penetration ratio, could indicate an important supervisory vulnerability. In addition, in the course of carrying out the FSAPs, a number of potential systemic issues[14] have been identified, some of which have quite subtle operational modalities. The issue of financial stability and systemic risk will gain prominence during the ICP assessments of more complex insurance markets. It also points to the need for further improvements in the ICP and the development of a taxonomy of systemic exposures in the nonbank financial sector.

[14] For example, in one country it was discovered that 70 percent of all credit insurance (mainly covering retail finance) was concentrated in one insurance company.

D. Insurance Supervision and Pension Systems

50. **In reviewing the assessment findings, it was noted that several insurance supervisors also had supervisory responsibilities for pension systems, which were reviewed as part of the FSAP process.** Whereas private pensions normally have limited implications for systemic liquidity (the potential exception being when banks act as fund managers and performance guarantees are required by law), they can have significant fiscal implications where government explicit or implicit guarantees are granted, and underfunding or investment subsidies are involved. The ICP does not specifically deal with pensions except to the extent that the insurance industry provides products that support the provision of pensions. Guidance is lacking for the insurance supervisors who also oversee the pension system. Furthermore, there are no international standards for pension regulation and supervision, although some regional attempts have been made. However, in future FSAP work, it would be useful, in discussing the financial sector and the role of insurance, to identify and discuss the significance of the insurance and pensions benefits and the extent to which they could impact the resilience and development of the financial sector.

E. Difficulties in Carrying Out Assessments

51. **Several factors have limited the efficacy of the assessment process thus far.** Assessments were influenced by the changes made in the ICP and the development of various standards underlying the principles. The shortcomings in the ICP and the Methodology, the measurement problems in terms of differing accounting and actuarial practices, and the resources required to actually go beyond assessing formal rules to issues and implementation and enforcement, have also constrained a uniform approach toward these assessments. In this regard, the IAIS self-assessment program is a welcome step and should facilitate the assessment under the FSAP, both in terms of the preparedness of the supervisory authorities and in fulfilling the pre-FSAP information requirements. In addition, further work is required on the ICP and the standards that are linked to these principles, so that supervisory systems can be strengthened and assessments can be more uniform.

F. Future Work

52. **There are two key future tasks, the first of which is to provide feedback and provide ongoing support to the IAIS as the ICP evolves in light of emerging experience.** Specifically, the areas identified for further improvements in the ICP should be considered by the IAIS when the re-examination of the supervisory principles is taken up in 2002. Their use in providing indications of macroeconomic and financial vulnerabilities also needs strengthening. The Bank and Fund staff would provide all possible assistance to the IAIS in this task.

53. **The second task is to continue developing the Methodology (with the IAIS) and the templates to ensure that the ICP assessments are appropriate and relevant, and carried out in a consistent manner, allowing for preconditions and the stage of development of the insurance market.** In addition, there is growing evidence that many member countries will be seeking post-FSAP advice and assistance to upgrade their insurance regulatory framework and supervisory capacity.

54. **Finally, preparation of comprehensive and objective self-assessments by supervisory authorities, in advance of the FSAP assessment, would also help the assessment process**. In particular, it will facilitate a more in-depth assessment of the strengths and weaknesses of insurance supervision, with enhanced focus on implementation, enforcement, and cross-sectoral issues. The Bank and the Fund are examining opportunities to work with the IAIS in running training programs for both FSAP assessors and country-level self-assessors. Progressively, with changes in the regulatory and supervisory guidance from the IAIS, the tools available for the FSAP will improve, thus enhancing the objectivity and completeness of the assessments of the insurance systems of member countries.

Insurance Core Principles

Organization of an Insurance Supervisor (ICP 1): The insurance supervisor of a jurisdiction must be organized so that it is able to accomplish its primary task, i.e., to maintain effective, fair, safe, and stable insurance markets for the benefit and protection of policyholders. It should, at any time, be able to carry out this task effectively in accordance with the Insurance Core Principles.

Licensing and Changes in Control (ICPs 2, 3): Companies wishing to underwrite insurance in the domestic insurance market should be licensed and the insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction.

Corporate Governance and Internal Controls (ICPs 4, 5): It is desirable that standards, which deal with corporate governance, be established in the jurisdiction. The supervisor should be able to review the internal controls and require the board of directors to provide suitable prudential oversight.

Prudential Rules (ICPs 6, 7, 8, 9, 10): Insurance companies should meet prudential standards established to limit or manage the amount of risk that they retain. Standards should be established in the areas of assets, liabilities, capital adequacy and solvency, derivatives and ''off-balance sheet'' items, and reinsurance.

Market Conduct (ICP 11): Insurance supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills, and integrity in dealing with their customers.

Monitoring and On-Site Inspection (ICPs 12, 13): Insurance supervisors should get the information they need to properly form an opinion on the financial strength of the operations of each insurance company in their jurisdiction.

Sanctions (ICP 14): Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified.

Cross-Border Business Operations (ICP 15): The insurance supervisor should ensure that: no foreign insurance establishment escapes supervision; all insurance establishments of international insurance groups and international insurers are subject to effective supervision; the creation of a cross-border insurance establishment is subject to consultation between host and home supervisors; and foreign insurers providing insurance cover on a cross-border services basis are subject to effective supervision.

Coordination and Cooperation (ICP 16): In order to share relevant information with other insurance supervisors, adequate and effective communication should be developed and maintained.

Confidentiality (ICP 17): All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities.