SM/01/266
Correction 1

August 30, 2001

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to SM/01/266 (8/21/01) have been provided by the staff:

Page 9, Table 1, stub Australia, column 2: for: "HIH Insurance…could continue operating."
read "HIH was a major…indemnity insurance."

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

Att: (1)

Other Distribution:
Department Heads

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 was a major liability underwriter in Australia. It collapsed in 2001 and an administrator was appointed. HIH was a major insurer of builders' liability and its demise disrupted conditions in the already weak construction sector. The failure of HIH also disturbed a number of other sectors, especially those which depend on professional indemnity insurance.
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.

1. **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.