Organisation for Economic Co-operation and Development

Publication sponsored by
the Japanese Government

INSURANCE AND PRIVATE PENSIONS COMPENDIUM FOR EMERGING ECONOMIES

Book 1
Part 1:1)b

DETAILED PRINCIPLES FOR THE REGULATION AND SUPERVISION OF INSURANCE MARKETS IN EMERGING ECONOMIES

Insurance Committee Secretariat

1997

This report is part of the OECD Insurance and Private Pensions Compendium, available on the OECD Web site at www.oecd.org/daf/insurance-pensions/ The Compendium brings together a wide range of policy issues, comparative surveys and reports on insurance and private pensions activities. Book 1 deals with insurance issues and Book 2 is devoted to Private Pensions. The Compendium seeks to facilitate an exchange of experience on market developments and promote "best practices" in the regulation and supervision of insurance and private pensions activities in emerging economies.
The views expressed in these documents do not necessarily reflect those of the OECD, or the governments of its Members or non-Member economies.

Insurance and Private Pensions Unit
Financial Affairs Division
Directorate for Financial, Fiscal and Enterprise Affairs

DETAILED PRINCIPLES FOR THE REGULATION AND SUPERVISION OF INSURANCE MARKETS IN EMERGING ECONOMIES

Although general guiding principles can be set forth for the benefit of the regulatory and supervisory authorities of countries in transition, those principles are applicable only if they are adapted to the economic environment as well as to the historical and cultural context of each country. Specifically, a number of regulations enforced in countries where the insurance sector has attained an advanced degree of maturity can only be progressively incorporated into economies in transition. Also, certain regulatory provisions that have long existed in OECD countries, but are nowadays no longer justified due to changes in the economic and regulatory environment of those countries, may be appropriate in light of the current stage of development of certain countries in transition.

In addition, insurance regulations should be flexible so as to evolve in accordance with changes in the economic environment and the insurance market. For that reason, it could be appropriate to incorporate certain provisions not in the law itself but rather in implementing regulations that are easier to amend. Maintaining this margin of flexibility is also perfectly compatible with preserving legal predictability, which economic agents require.

In order for the regulations to have the desired effect, they should stipulate obligations as well as provide for realistic penalties in the event of non-compliance with the applicable statutory and regulatory provisions.

Finally, special mention should be made of the importance of having different regulations applying to life and non-life insurance. Each of those branches operates under its own constraints and requires specific management and regulatory structures.

The paragraphs which follow contain observations concerning some of the fundamental aspects of insurance regulation and supervision to be addressed by economies in transition. The order and length of these paragraphs should not be taken as an indication of their relative importance as regards the policies governing insurance.

Licensing

Sufficiently strict conditions governing the formal approval of insurance companies serve to guarantee the protection of insurance users and ensure that fair, competitive conditions exist among companies in the domestic market. In most OECD countries, separate licenses are issued for each class of insurance (or for several classes grouped under a common denomination) usually in the six months following the filing of applications, and they are generally permanent.

Experts agree on the importance of a certain number of criteria that must be met by an insurer seeking to be licensed. Among those, the first may be the strict testing of the nature and adequacy of the financial resources of insurance companies at the time they go into business, an essential condition for ensuring that they have the financial strength needed to operate. The minimum required capital is that which would enable a company to meet certain contingencies inherent in its business. The amount of such capital (expressed in a manner that takes inflation into account) varies according to the insurance class in question and to the specific conditions prevailing in different markets. Lastly, a deposit, either of a fixed or variable amount, may be required in addition to the minimum capital requirement.

In addition to these financial standards, economies in transition should not fail to impose other licensing criteria, which have been used in all OECD countries. They concern in particular:

- legal requirements, *i.e.*, in particular, conformity of the form of business organisation adopted by the company, filing of bylaws and general terms and conditions of policies, insurance specialisation;
- accounting requirements, *i.e.* filing of opening balance sheet, budget and income statement, proof that the company has the required minimum capital, etc.;
- technical requirements, *i.e.* filing of premium rates for information or, if applicable, for approval, as well as of the technical bases used in tarification and planned technical provisions, and of reinsurance contracts;
- managerial requirements, *i.e.* demonstration that officers are fit and proper, and that the shareholders are reputable.

Supervision of insurance companies

In many economies in transition policyholders are highly vulnerable because they lack access to reliable information on products, intermediaries and insurance companies, while insurers are still short on training and experience and there can be significant gaps in regulatory coverage. The implementation of adequate supervision for the insurance sector would be a first step towards removing those deficiencies.

Regardless of which structure is chosen for supervisory bodies (independent authority, ministry of finance division, etc.), experts in charge of supervising insurance companies must be properly trained and impartial.

The examination of records is at the core of the work of supervisors. They analyse records supplied by insurance firms and may request any additional accounting or business document they deem necessary for their audit. Thorough on-site investigations are an indispensable complement of audits of records. *A priori* supervision is also particularly recommended in countries where economic structures and comprehensive regulations have not yet been developed. The prevention and detection of insurers' financial problems would enable the supervisory authorities of countries in transition not only to safeguard the solvency of companies, but also, in a more general way, to promote public confidence in recently privatised institutions within a business sector about which the public may still be unfamiliar.

The duties of supervisory authorities should focus on the following general areas:

- supervision with respect to legal obligations: compliance with existing legal provisions, by-laws of the company, general terms and conditions of insurance policies;
- financial supervisions: own funds, technical provisions, assets, monitoring of business activities;
- audit of interim and annual financial statements;
- actuarial supervision: tariffs, technical or mathematical provisions;
- management supervision: fit and proper requirements of company officers, reputation of strategic shareholders;
- economic supervision: conditions prevailing in the marketplace, statistics.

Initially at least, it may be advisable in economies in transition to submit premium rates for prior approval. This practice would efficiently safeguard the financial soundness of insurance companies, which might otherwise be tempted to engage in rate wars, thereby running the risk of putting their solvency in jeopardy. On the other hand, excessively high tariffs would penalise policyholders. Above all, in economies in transition, the lack of experience of insurance management, combined with the shortage of basic statistical data such as the frequency and severity of losses, can make it difficult or, indeed, impossible to set premiums rates based on actual risk exposure.

Regulatory and supervisory authorities may therefore have to draft regulations on premium rates on the basis of probability assumptions. In addition, they will have to compensate for the difficulty of individual data collection by seeing to it that a national body of statistics is being established.

Similarly, it seems advisable that the insurance products offered for sale be examined by the supervisory authority, so that consumers will not be harmed by inappropriate policy conditions. The risk of asymmetry in the information available to the insurer and to the insured is even greater in economies in transition, due to insufficient disclosure of information on insurance products and companies.

Supervision of premium rates and policy conditions must 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.

Prudential rules in OECD countries also include requirements for solvency thresholds or margins which correspond to the minimum amount of capitalisation required for the type of business written by the company, in order to cope with the contingencies associated with that business or to offset any shortfalls in the technical provisions set aside. That margin, which is computed for individual companies on the basis of their commitments, constitutes the first step towards dynamic supervision. It may be appropriate for it to reflect as much as possible the nature and diversity of the risks to which the company is exposed, using as models those recently developed by certain OECD Member countries. Nevertheless, a solvency margin that matches regulatory standards should not be deemed by the management or supervisory authority to be the end-result of the assets-liabilities management and a fail-safe guarantee of the financial soundness of the company under consideration. Furthermore, the mechanism for setting margins may be affected in a situation of high inflation. Above all, the margin is only an instrument for measuring and monitoring solvency; adequate tarification, investments that correspond to technical commitments and sufficient technical provisions remain the main pillars of solvency.

The setting aside of technical (or mathematical) provisions in an amount sufficient to meet at all times the company’s commitments vis-à-vis the insured remains at the very core of insurance business. Most countries have agreed on the definition of technical provisions to be set aside. Among those, the following non-life provisions can be quoted: provisions for unearned premiums, provisions for unexpired risks, provisions for claims outstanding or equalisation reserves.

The method used for setting the amount of these provisions, whether imposed or regulated, should be based on national statistical data. At first, it is likely that computing for the purpose of setting technical provisions will have to be based on probability assumptions, owing to the absence of reliable nation-wide statistics (such as mortality tables for life insurance) in most countries in transition.

It seems essential that the supervisory authorities be given adequate sanction powers in the event insurers fail to comply with legal provisions governing the setting aside of technical provisions. Under these circumstances, it would in particular be advisable that a company no longer has the unrestricted use of its assets.

More generally, in order to perform adequately its duties, the supervisory authority will have to develop an on-going dialogue with insurers so as to appear as a partner of companies’ success, instead of being confined to a coercive role.

Investments

In OECD countries, regulations governing the management of assets are based on a list of "admissible" investments. In order to ensure that requirements of both safety and profitability are respected, countries in transition may also adopt a series of principles (listed below), which have proved useful in this respect in more advanced markets.

Diversification, spread and liquidity

Ceilings may be set on admitted investments, by type of investment and in percentage terms rather than in absolute value, so as to reduce the risk of default or of liquidity shortages associated with certain types of investments, as well as to ensure that portfolios are sufficiently diversified. A ceiling may also be set for given investments (according to the principle of spreading investments within each category). Although OECD countries now very seldom set floor limits, such practices were sometimes used in the past, especially to encourage investments with a low risk of loss or lack of liquidity.

When setting ceilings, the impact of the method used for establishing the value of investments must be taken into consideration (for example through a prudent assessment of investments). Lastly, insurance companies are generally advised against having recourse to debt to finance long-term investments.

At this stage, regulatory and supervisory authorities should make sure that a distinction applies between the treatment of investments representing technical reserves and that of investments of the capital base. The latter has a role to play in the long run, particularly with respect to the funding of the company's future growth, and it would be sound policy to let companies earn a high return on the investment of their capital base, so that they may reinforce their financial resources. However, the buffer effect of the capital base in its role as a complement to technical provisions and possible equalisation reserves may serve as grounds for justifying restrictions placed on investments of these funds. Thus, one will also have to distinguish, within owners' equity itself, between the minimum required capital and the free capital. While there is a need for regulations on the investment of the minimum capital - which ought to be readily available to pay exceptionally high claims - those concerning the investment of the free capital seem less justified.

Localisation

The domestic location and/or custody of certificates of investments corresponding to technical reserves can be of particular importance in countries in transition. This makes it possible for them to ward off two problems to which they may be exposed more frequently than OECD countries, namely difficulties in establishing proof of ownership and the possibility of fraud by companies. Those provisions should not constitute an obstacle to the balance of investments.

Currency matching

The currency matching rule refers to the fact that investments ought to be in the same currency as commitments. In the case of economies in transition, the current fragility of their national currency as compared to those of foreign countries in which foreign investments can be made, may lead to tolerate a certain degree of flexibility. Regulations should simply state in what foreign currencies investments may be made. Also, arguments in favour of the matching of currencies in which the shareholders' equity of companies is invested are less convincing. Lastly, the fact that a national currency is fragile justifies even more that insurers and reinsurers should at least be authorised to hold foreign-currency reserves in the

amount of their commitments payable in those currencies; this is the case, for instance, for reinsurance policies between domestic insurers and foreign reinsurance companies.

Maturity matching

One of the primary objectives of insurance companies in managing their assets, in particular in the life-insurance sector, is to ensure that the maturity of those assets matches that of their commitments, so as to reduce the risk of changes in interest rates. Partial and temporary exemptions from that rule may be considered in certain countries, given their economic situation (tightness of capital markets, rampant inflation, concerns about investments in domestic securities, etc.).

Insolvency and management of troubled companies

Clear instructions should exist regarding what is to be done about insolvent insurers through legislation covering all matters connected with the management of troubled companies, including standards used to establish insolvency, the basis for choosing between rehabilitation and liquidation, recovery measures available (premium rate increase, freezing of assets, request for reinsurance plans, injection of capital, etc.), the revocation of licenses, conditions under which policies may be transferred to a sound company (often resulting in the rights of policyholders being safeguarded), the role of the liquidator and the ranking of creditors' claims.

In most OECD countries, it is generally accepted that supervisory authorities should do everything in their power to prevent an insurance company from defaulting, as this would be damaging to the entire insurance sector.

Some countries have also opted in favour of guarantee funds which pay the claims of insolvent companies. However, in countries in transition, the advisability of creating such a fund should be assessed by looking at its costs, which could weaken participating companies, and at the possible aggravation of moral hazard that the establishment of such a fund may cause - as compared with the possible benefits derived from it.

Liberalisation and competition in the insurance sector

While implementing a programme of removing monopolies and privatising state-owned companies, economies in transition are preparing for the advent of a globally competitive insurance market. In this connection, the regulatory and supervisory authorities of countries in transition would be well advised to ensure that state-owned companies and private firms are treated equally, although it may be justifiable to hold on to certain exclusive rights, such as in the field of export credits and political risks, which are generally areas covered by companies run by the state.

The danger inherent in a policy of closed markets should also be underscored, and competition encouraged, free of discrimination based on companies' nationality. The presence of subsidiaries or branches of foreign insurers, as well as the acquisition by foreign companies of minority or majority interests (the restriction of ownership to a minority of the shares may dissuade foreign companies from entering the market), contribute to the development of the domestic insurance sector. Foreign presence brings with it innovation and transfers of know-how, while at the same time giving access to additional financial resources, improving insurance rules, fostering greater diversification of business, expanding capacity so that a steep growth in demand will not be held back by the small size of the domestic insurance sector, broadening the scope of products offered and increasing financial security, to mention only the main advantages. While prudential regulation of investment is necessary, discriminatory provisions or practices

which would constitute obstacles to investments by foreign insurance companies should be avoided and the adoption is recommended of a relatively liberal attitude towards exchange controls.

Distribution of insurance products

The emergence of new insurance companies and new insurance products requires the development of modern distribution networks, with the possibility of an adequate combination of several types of intermediaries (insurance company staff, agents, brokers, direct sales, etc.). Considering that in many cases only intermediaries have contact with consumers, it might be recommended that regulations covering intermediaries be adopted, at least insofar as brokers are concerned (insurance companies being often in a position to exercise at least indirect control over agents). These regulations would cover issues such as registration, required business qualifications and ethical standards, along with financial security (including the need for professional liability coverage).

Supervisory authorities should see to it that intermediaries conduct their business as transparently as possible; specifically, they should disclose to their clients their status on any ties that they may have to insurance companies, along with providing extensive information on, and explanations of, policies to policyholders.

Insurance accounting

Accurate accounting provides authorities with the practical means to perform proper supervision, while at the same time being a resourceful instrument for the management of companies.

Widely available financial statements and proper financial information are important assets both for the supervisory authorities and the insurance market. That is why, in OECD countries, insurers are required by law to issue financial statements certified by an independent auditor as fair and accurate.

There is no doubt as to the advantage of standardising accounting rules at the national level in terms of disclosure and comparability of the financial positions of companies (this concerns mainly the presentation of annual financial statements, evaluation rules, the contents of notes to the financial statements and of the annual report, the presentation of consolidated financial statements, auditing and publication, as well as sanction measures).

Among the accounting problems encountered in economies in transition, those having to do with valuation and assessments are particularly thorny. The evaluation of technical commitments should for instance be made through several approaches involving looking at past and future performance. In several countries in transition, owing to the absence of a genuine market, prudential rules may play a particularly important role in the valuation of assets, regardless of the assessment method used (none has been universally endorsed, even within the OECD, where certain countries use book/acquisition value and others emphasise market value). In addition, a periodic reassessment of certain assets, such as buildings, seems necessary. Lastly, it is important to make allowance for inflation, which is high in many of those economies and makes it even more difficult to keep a prudent and fair accounting that accurately reflects the financial position of companies.

Statistics

The compiling of nation-wide statistical data, particularly regarding the frequency and severity of losses (mortality tables in life insurance) is a *sine qua non* condition for computing tariffs and technical reserves accurately. Compiling could be done by the supervisory authority or by a specialised body. It would make sense that it focuses initially on key insurance classes, such as automobile liability insurance and fire insurance.

Furthermore, the creation of a reliable statistical instrument is the only way for insurance companies to demonstrate to the tax authorities that they are justified in setting aside certain amounts to cover their commitments.

Contract law

In an environment where markets are opening up, the insurance sector is rapidly expanding, and the number of participants and complexity of products are on the rise, the protection of insurance policyholders in economies in transition also requires the enactment of a contract law or the improvement of the existing one. It is a way for lawmakers to bring the rights and obligations of the parties into balance and to devise sanction measures proportionate to the violations committed.

A certain number of general principles, which served as guidelines for the enactment of contract laws in OECD countries, may be listed for the benefit of countries in transition. For instance, the distinction between policies providing for indemnities and those paying flat sums should be clear, including the various legal consequences thereof (differences in the amount of compensation in the event of a loss in particular). The importance of establishing the exact time at which contracts are executed and go into effect, their life, as well as the issue of proof of contract, should also be underscored. A contract implies obligations on the part of the company but also on that of the insured, including that of declaring loss exposure (and the possible aggravation thereof), paying premiums and reporting damages or losses. The possibility that a policyholder may be underinsured should not be overlooked, anymore than that of intentional losses or wrongful conduct, which constitute grounds for exclusion from coverage. In order to be complete, insurance contract law also needs to refer to the rights of third parties to compensation or with respect to the insurer, as well as providing for the modalities of disputes settlement.

Besides the technical aspects of contract law, some leeway is left for each government to determine the degree of protection it wishes to provide for policyholders, with due regard to the cost of restrictions under consideration and to the supervisory capabilities they require.

Compulsory insurance

Insurance is made compulsory out of a desire to protect the whole or part of the public. In addition, compulsory insurance enables the state to cease being financially responsible for certain losses which they otherwise would have to compensate.

With the exception of automobile liability, it is hard to suggest for which kind of risks insurance cover should be compulsory. The need for certain types of compulsory insurance will be appraised differently from one country to another. At most, it can be stated that compulsory insurance seems advisable in the case of the following types of cover:

- in branches which are more closely related to the social sector than to private insurance;
- in specific areas where compulsory insurance is justified by the seriousness of risk exposure and/or by its generalised nature (automobile liability or occupational accidents for instance);
- in areas where premium payments should be divided on an equitable basis among the policyholders group under consideration.

Lastly, insurance can reasonably be made compulsory only in those sectors for which effective oversight is available at a reasonable cost.

Concern for losses incurred by third parties may also justify the implementation of mechanisms that serve to compensate for non-compliance with insurance requirements, or for the default of an insurer (*e.g.* guarantee fund for automobile liability insurance).

In most instances, the setting of uniform rates is not required, since competition will normally have an impact in the field of compulsory insurance as for other insurance categories. Should it be deemed preferable to set rates, it is important that tariffs take into account available statistical data and the economic situation of the sector under consideration.

Specialisation

Specialisation by companies along the lines of life and non-life insurance ensures that assets are managed separately and that losses incurred, for instance, in the non life-insurance sector will not affect life policyholders.

At the inter-sectoral level, the experience of OECD countries calls for prudence with respect to structures of the bank/insurance type, at least at this stage of development of the markets of economies in transition. The technical specificities of these businesses (such as that of non-life insurance for instance, whose management is highly complex, both in the setting of insurance premium levels and in assessing claims and how to compensate for them), along with the specificity of prudential rules applicable to the insurance sector, the risk of transfers of credit or dividends, exposure to conflicts of interest, contagion involving various constituent parts of a conglomerate or double gearing are just some of the reasons why these structures should be carefully monitored.

Taxation of life insurance

In light of the potential economic and social role of life insurance in countries in transition as well as of the obstacles to the purchase of life insurance (high rate of inflation, absence of insurance culture, very high nominal interest paid on cash savings, lack of knowledge about products, impossibility to guarantee an attractive rate of return on long-term policies, etc.) the establishment of tax incentives may be considered in order to promote this market. Incentives could for instance come in the form of tax deductions or credits for premiums paid by individuals on certain policies. Premiums paid by employers on policies providing reasonable life-insurance benefits on behalf of employees could also be tax deductible by employers and employees would not have to pay taxes on them.

Lastly, regardless of the tax model selected, it seems particularly advisable to keep its administration very simple in countries which often lack the means to enforce tax compliance.

Actuaries

The complexity and specific nature of actuarial work warrants encouraging the promotion of the actuarial profession. Actuaries can contribute in a useful way to the performance of very important tasks by insurance companies, such as calculating premium rates, calculating the amount of technical provisions, assessing contractual obligations, as well as preparing financial reports, monitoring solvency margins, developing insurance products, consulting on investment strategies, participating in the development of computer systems or making arrangements for reinsurance. In almost all OECD countries, insurance companies are required by law to appoint actuaries. This precaution seems all the more relevant at an initial stage, in order for this profession to be recognised.

Reinsurance

Adequate and effective reinsurance enables insurance companies to share risks with others, limit losses from large risks and, in a more general way, to streamline their risk portfolio and to allocate technical income and expenses over time. In many ways, such objectives are incompatible with regulations still in effect in certain economies in transition, in particular those concerning the compulsory cession of reinsurance. Only through free access to the wider international reinsurance market can the ceding company be ensured of getting the best product at a competitive price.

In addition, supervisory authorities should endeavour to protect insurers against the collapse of reinsurers. Supervisory authorities could start out by monitoring reinsurance transactions through an audit of the financial statements and notes thereto (in particular reinsurance agreements) of ceding companies. It is also very useful to compile as much information as possible on reinsurers, their solvency and liquidity (including through rating agencies), as well as, more generally, on the overall impact of ceding risks, taking into consideration all significant transactions with respect to claims, commissions and brokers' fees. Supervisory authorities from different countries may wish to consider working closely together in this area.

Private pension systems

The governments of OECD countries as well as of many economies in transition are experiencing growing difficulties in supporting pay-as-you-go pension systems. Current pension systems are therefore bound to be revised, while funded systems should grow in importance. In this context, the private sector will become responsible for a progressively larger share of pensions. At a macro-economic level, this trend is expected to provide a powerful boost to long-term savings. Hence, consideration could be given, among others, to tax incentives and regulations aimed at promoting the establishment of employee pension plans by employers. The role played by insurance companies in the financing of private pension systems will also have to be examined.