

The regulation of non-life insurance in the United Kingdom

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Abstract

This paper outlines the main principles of supervision of general insurance companies in the United Kingdom, and of Lloyd's of London, with particular emphasis on prudential regulation and the role of actuaries. Some international trends in insurance supervision are identified and indications given of how supervision may develop in the future, in the light of the role of the International Accounting Standards Committee in setting accounting standards and the role of the International Association of Insurance Supervisors in developing globally accepted standards for insurance regulation.

Keywords

Regulation; solvency; Lloyd's of London; actuary; dynamic financial analysis

Introduction

General Insurance contracts began to be underwritten from very early in London. There is evidence of marine insurance in London by 1426 (Lewin, 1990). Probably only Genoa and Venice had insurance contracts before this (Lewin, 1987).

The Office of Assurances was established in 1575 in the Royal Exchange, at the instigation of the Privy Council (Lewin, 1987a, 1988), to co-ordinate and begin to control the writing of insurance, which was primarily marine insurance, although some life insurance was written on a short-term basis, on principles similar to general insurance.

In the mid 18th century, long term life insurance began to be developed in London. Although this was business that was carried on by mutuals (and friendly societies), major general insurance companies also began to transact life insurance business.

Rapid growth and the subsequent demise of a few high profile life insurance companies in the 1860s led to the first moves to establish a regulatory regime. However, when this eventually emerged, it was restricted to life insurance (the Life Assurance Act 1870). This established the principle of separation of the assets of the life and annuity business into the "long-term business fund", which was subject to actuarial reporting and control. This was

particularly important for the large number of composite companies, to protect the life insurance business from possible contagion in case of financial pressures on the general insurance business.

Actuaries showed some interest in the general insurance operations, but were not to be given any statutory role, this being restricted to the long-term business fund. Much general insurance was at that time quite short term, being predominantly property insurance, with fire being the most important risk covered in this class.

Exceptions to the predominantly short-term nature of the business were the marine and transport risks, which were primarily underwritten by Lloyd's of London. The relatively protracted period over which claims emerged under these contracts was reflected in the three year accounting system which was developed at Lloyd's. Originally this simply accumulated the premiums paid and deducted the claims payments made from each underwriting year. No profit (or loss) was struck until the end of the third year, with, in effect, the whole of the excess of premium income over claims paid being reserved against outstanding claims and IBNR.

Legislation governing the conduct of Marine Insurance business can be traced back to the first half of the 18th century. Modern solvency regulation of general insurance business was first introduced in 1909, when the previous Acts were replaced by more comprehensive insurance company legislation, which also covered fire insurance, accident insurance, employers' liability insurance and bond investment business. However, there was very little pro-active supervision, even of life insurance companies, at that time in the UK. The principle was of "freedom with publicity". Insurance companies could charge whatever they liked, and manage their financial affairs as they wished. However, they should publish their annual financial statements. This "publicity" was regarded as an important control on their behaviour and an incentive to develop a strong balance sheet.

During the 20th century, motor insurance developed into an important line of business and the general insurance market diversified into many different product lines. Many of the larger companies worked together to some extent and industry-negotiated "tariffs" meant that there was no premium rate differentiation within these groupings in major classes such as fire and motor insurance, although there were always a few "non-tariff" companies.

The UK general insurance industry received a wake-up call in the mid 1960s with the scandal of the Fire, Auto and Marine Insurance Company systematically defrauding policyholders. Further excitement came when a new entrant to the motor market, Vehicle & General, ignored the tariff, adopted an entirely new rating system, swept to a dominant position in the market and then collapsed into insolvency (Report of the Tribunal, 1972).

These events, together with an increasing level of international co-operation and discussion through the OECD (Campagne (1957, 1961), and then through the newly-established European Community, led to an increased acceptance of the role of government in developing enhanced regulation and actively supervising compliance by insurers.

Actuarial and statistical methods were also beginning to become more widely accepted, if not as the first choice of insurance companies in establishing their provisions, then at least as a sensible means of checking on reasonableness, and as a tool of supervision. A formal requirement for insurance companies to prepare run-off information and publish detailed

claim run-offs and premium exposures as part of their statutory returns to the Board of Trade (the government department with responsibility for the insurance industry) enforced this "best practice" discipline on the whole industry. Unfortunately it came too late to permit sufficiently timely intervention in the case of Vehicle & General. Arguably, the run-off information would in any case have been of little value, because the company was growing so rapidly. Nevertheless, the development of run-off information to meet regulatory requirements led to a radical reappraisal of information systems and record-keeping, and opened up the way to a rapid rise in the involvement of actuaries (and statisticians) in more scientific monitoring of the business. From the regulatory side, this led to a development in the role of actuaries in the Government Actuary's Department as advisers to the (by then) Department of Trade and Industry on the financial strength of general insurance companies.

The European Union Directives

By the time that the United Kingdom joined the European Economic Community (subsequently to become known as the European Union), the First Non-Life Insurance Directive had already just been negotiated by the six founding countries and automatically became a requirement for the UK to implement. Further details of the events leading up to this Directive, and in particular the discussions within the OECD Insurance Committee, and its predecessor, can be found in Daykin (1984).

The essence of the non-life establishment directive (the First Directive – European Communities, 1973) was to create a common solvency regime to underpin mutual recognition of supervisory systems. Each insurance company was to be supervised in respect of its entire (worldwide) business by the supervisory authority in the member state where the head office was situated. Permission to continue to underwrite business was to be subject to the maintenance of an adequate excess of assets over liabilities – the solvency margin – which had to meet minimum requirements.

The required solvency margin for general (property/casualty) insurance companies is calculated as 18% of net premium up to 10 million euros (formerly écus) of premium income, and 16% of premium income above that level. An alternative basis of calculation involving 26% of net incurred claims up to 7 million euros, and 23% of claims above that level, applies if it yields a higher result.

This is a slight oversimplification as reinsurance could only be taken into account in reducing the gross premium (or claims) by a maximum of 50%. It should be noted that the directive did not lay down any rules concerning the valuation of either assets or liabilities, this being left within the jurisdiction of the supervisory authorities (or regulations) of the individual member states.

On the strength of the monitoring of these solvency margin requirements by the home country supervisor, insurance companies were permitted to establish branches in other EU countries. The so-called host country supervisor did not need to be concerned with the overall financial condition of the company but could restrict attention to the branch having assets to meet its liabilities.

Apart from opening the way to freedom of establishment (of branches), the establishment directive clarified the basis on which supervisors could intervene in the affairs of a company. The idea was that such intervention would generally be limited, provided the company

maintained the required minimum margin of solvency. If the excess of assets over liabilities fell below the required minimum margin of solvency, the supervisor would ask the company to prepare and implement a "plan for the restoration of a sound financial position".

A further trigger point was set at one-third of the required minimum margin, subject to a minimum in absolute money terms (according to the class of business). If the excess of assets over liabilities fell below this level, known as the "guarantee fund" (although with no connection to the use of this term elsewhere in connection with compensation or fall-back funds), then the supervisor could require the company to prepare a "short-term financial scheme", which would normally imply the injection of capital or some form of capital reconstruction or sale of the business. Failure to put in place such an arrangement expeditiously provided grounds for the supervisor to withdraw the company's licence to underwrite new business.

Discussions continued within the EU to create a single market in insurance, where cross-border activity was not limited to establishing branches in other countries but included the right to "freedom of services", namely the possibility of writing insurance business across borders without establishment of a branch in the "host" country. This was achieved by the Third Non-Life Directive which was agreed in 1992 (European Communities, 1992).

The considerable elapse of time between the first and third directives (the second directive took a modest interim step in opening up the commercial insurance market in 1988 (European Communities, 1988)) may be in part ascribed to the difficulty of achieving co-ordination at the European level in respect of asset and liability evaluation, although undoubtedly the desire to protect local markets played a part, together with a reluctance on the part of some member states to accept the complete removal of controls over products, policy wording and premium rates.

The issue of co-ordination of asset and liability valuation was, in principle, resolved for general insurance by the passing of the insurance accounts directive (European Communities, 1991). However, the general principles laid down are at a very high level and it is not clear that all member states interpret them in a similar way. Article 56 of the accounts directive requires that "the amount of the technical provisions must at all times be such that an undertaking can meet any liabilities arising out of insurance contracts as far as can reasonably be foreseen". It is still a matter of interpretation as to the level of prudence that is intended by this phrase, or whether provisions are to be established as best estimates. The insurance directive did legitimise discounting of provisions for general insurance, at least for business with a mean outstanding term of 4 years or more, although it is left to member states to decide whether to implement this.

The third directive ushered in, with effect from 1 July 1994, freedom of services and a single licence régime. An insurer is now required to seek authorisation (obtain a licence to write business) in only one of the member states, in order to have the right to write business, either on a cross-border freedom of services basis or through a branch, in any of the other member states of the EU. Supervision is by the "home country" supervisor where the licence is obtained. The home country supervisor is responsible for ensuring that the company's financial strength is adequate on a global basis, including compliance with the required solvency margin. "Host" country supervisors should only intervene in cases where insurance contracts being sold may contravene the "public good".

Insurance regulation in the UK

For many years insurance regulation in the UK was the responsibility of the Insurance Division of the Department of Trade and Industry (DTI), under the framework of the Insurance Companies Act 1982 and subsequent regulations. In January 1998 responsibility passed to H M Treasury (HMT) and in January 1999 the supervisory activity was delegated by Treasury to the Financial Services Authority (FSA). New framework legislation was passed in 2000 (the Financial Services and Markets Act 2000) and full responsibility for supervision of financial institutions, including insurance companies, will pass to FSA under this Act later in 2001.

DTI, HMT and now FSA have successively all been advised on technical and actuarial issues by the Government Actuary's Department (GAD), which provides an actuarial consultancy service to many government departments, agencies and other public sector organisations. However, from the end of April 2001, the actuaries at GAD who advise the FSA will transfer to become employees of the FSA and will continue to provide an internal actuarial consultancy service to the supervisors.

UK supervision, as intimated earlier, has for many years relied on "freedom with publicity". There was no regulatory control over products or premium rates, or over insurance company investment policy. Supervision was focussed on whether the management and control of the company was "fit and proper" and on the strength of the company's balance sheet. Issues of investment risk, and the need for diversification, were addressed through asset valuation rules, rather than through direct controls on investment.

As a member state of the EU, the UK is bound by the insurance and insurance accounting directives. In particular, the UK requires companies to maintain an explicit excess of assets over liabilities of at least as much as the required minimum margin of solvency under the first non-life directive.

Assets are required to be valued at market value, or a proxy for market value where no ready market exists. Liabilities are valued in accordance with generally accepted accounting principles, but are not subject to any detailed regulatory requirements, except to stipulate the sorts of provisions required and to permit discounting of future liabilities in accordance with the insurance accounts directive. Additional guidance is available in a Statement of Recommended Practice (SORP), prepared by the Association of British Insurers.

Apart from drawing up accounts for reporting to shareholders, general insurers are required to submit annual returns to the FSA in a prescribed form. These documents are placed on public record, as well as forming the basis for financial monitoring of companies by the supervisor. They include information about:

- the distribution of assets held
- unearned premium provision
- provision for unexpired risks
- outstanding claims provision (including IBNR)
- information gross and net of reinsurance
- disclosures concerning major reinsurers

Regular monitoring of the insurance companies' financial condition by the supervisor has regard to an analysis of the annual returns. These returns demonstrate explicitly whether the

solvency margin requirements have been met at the balance sheet date. For this purpose assets are required to be valued in accordance with asset valuation regulations. Apart from stipulating the basis of valuation (e.g. market value for quoted securities), these also limit the extent to which certain assets may be taken into account, both to prevent companies relying on exceptionally risky assets to support their statement of solvency, and to avoid reliance on concentrations of particular types of asset or securities from particular issuers. For example, the value of a single property cannot be taken into account to an extent greater than 5% of the general insurance technical provisions.

These asset valuation rules are not intended to prevent insurance companies from investing in whatever investments they choose, but they do in effect limit that freedom unless the company has free assets substantially in excess of the level required to cover the technical provisions and the required minimum margin of solvency.

The validity of the company's declared solvency position depends heavily on the way in which the technical provisions are calculated. Obviously an understatement of these provisions could give a misleading impression of the financial strength of the company. One of the main tasks of the supervisor is to monitor the appropriateness of the technical provisions. In the UK the supervisor does this by means of a variety of tools. Firstly, there is the responsibility placed on the independent external auditor to confirm that the accounts have been drawn up in accordance with generally accepted accounting principles. Secondly, the supervisor utilises software to perform an initial analysis of the company's annual returns. Thirdly, there is the possibility of referring the company's returns to GAD for fuller analysis. Lastly, there is the power to require the company to have a full-scale independent actuarial review of their technical provisions or overall balance sheet.

General insurance companies in the UK are not required to appoint an actuary, or even to take actuarial advice. However, it is increasingly common for companies to have access to actuarial advice, and the supervisor can insist on this if there are concerns about the adequacy of the technical provisions, particularly if such doubts call into question whether the required minimum margin of solvency is in fact present.

Companies are permitted to discount their provisions in respect of longer tailed lines of business, but should be able to demonstrate that this has been done in accordance with reliable data and appropriate actuarial modelling techniques.

Companies are also permitted to set up provisions net of expected reinsurance recoveries, but they should set up prudent bad debt provisions if there is any doubt about recoverability. Details of the most significant reinsurance exposures are recorded in the returns.

Lloyd's has historically been subject to a system of self-regulation governed by internal bye-laws made under the 1871 Lloyd's Act (and the 1982 Lloyd's Act) and has had exemptions from the provisions of Insurance Companies legislation from the 1909 Assurance Companies Act through to the Financial Services and Markets Act 2000. The DTI had a limited role in the supervision of Lloyd's of London, which was primarily focussed on ensuring Lloyd's met its annual global solvency test (in effect looking at Lloyd's as a whole as though it were a single insurance company and applying the EU solvency margin requirements at that level).

International trends in insurance supervision

As insurance markets become more and more global, insurance supervisors are increasingly watching developments elsewhere in the world and learning from each other. This process is being accelerated by the International Association of Insurance Supervisors (IAIS), which has achieved a high level of participation from all countries with a significant insurance industry and most smaller countries as well. The IAIS has adopted a set of 17 Core Principles (see Annex) and is developing a series of standards for insurance supervisors, which are expected to be influential in spreading good practice globally. Inevitably, this also means that to achieve widespread acceptance of ideas, it is important to influence key committees within the IAIS.

For actuaries an important part of this process is the relationship between the International Actuarial Association (IAA) and the IAIS. The IAIS has been admitted as an Institutional Member of the IAA and the IAA is now an Observer Member of the IAIS. Close liaison has been developed between the Insurance Regulation Committee of the IAA and the Technical Committee of the IAIS, which, among other matters, is concerned with IAIS standards in relation to technical provisions, solvency, capital requirements and use of experts, such as actuaries and auditors.

It is noteworthy that the IAIS Core Principles do not include mention of controls on products or premium rates. This is one of the most significant shifts in supervisory philosophy which has taken place in recent years. Mention has already been made of the Third (so-called "framework") Life and Non-Life Directives of the European Union, which outlawed prior controls of products and premium rates in the EU. Although there are still many countries which do have controls of this sort, there seems little doubt that the trend is moving away from such controls.

A consequence of this is an increased emphasis on monitoring financial strength as a key pillar of supervision. This can be considered at three levels:

- 1) adequacy of assets to cover technical provisions,
- 2) capital and surplus requirements and
- 3) dynamic considerations

Although insurance supervisors still discuss the merits of different approaches to asset valuation and the incorporation of prudent margins into the determination of liabilities, it is becoming increasingly clear that international accounting standards may prove to be the defining factor. The International Accounting Standards Committee (IASC) has embarked on a project to set an international accounting standard for accounting for insurance contracts. Although this is still at a relatively early stage, it is not difficult to see which way the wind is blowing. In particular, the IASC has given a clear indication that they see insurance contracts as a special type of financial instrument. Proposals for accounting for financial instruments are heading strongly in the direction of fair value accounting and there seems every reason at this stage to expect that this is where the insurance accounting standard will end up.

Insurance company assets will almost certainly have to be valued at fair value as a result of requirements relating to accounting for financial instruments. Insurance liabilities will most likely (and necessarily, if consistency is to be achieved) also be required to be held at fair value. Fair value for assets is in principle market value, or a proxy for market value where

no deep market exists. Fair value of liabilities is, conceptually at least, the price which would need to be paid to a willing third party to take over responsibility for meeting the relevant liabilities.

Since there is no regular market in insurance contract liabilities (although reinsurance markets may provide a proxy), there are some concerns about how fair value of liabilities will be assessed. In practice this may be less of a problem for general insurance liabilities than for life and pensions business. It seems clear that fair value will incorporate discounting to allow for the time value of money. The most uncertain aspect is the extent of any margins for risk. Fair value is not intended to incorporate margins for conservatism or prudence as such, but should include whatever risk margin it would be necessary to build into the price to persuade a third party to take over the liability. Some financial economists would argue that this should only be a premium for non-diversifiable (systematic risk), but in practice most insurers would argue that there must be a premium for assuming risk, even if it can be to a significant extent diversified (otherwise reinsurers would never be able to make a profit from diversifying industry-wide risk!).

Insurance supervisors generally (including the IAIS Accounting Committee) have not been fully convinced by these accounting arguments, since many of them prefer to see technical provisions established on a prudent basis, so that a company with assets to cover technical provisions has a significantly higher than 50% probability of being able to meet all its liabilities.

It can be argued, from a purely theoretical point of view, that it does not matter whether technical provisions are established on a fair value or prudent basis, provided that solvency margin requirements (excess of assets over liabilities) are set which are appropriate to the asset and liability valuation regimes. The comfort element, from a supervisory point of view, is that a prudent approach to technical provisions would make it more likely that a company could run off its liabilities successfully, even after being stopped from transacting new business because the solvency margin had been eroded.

A practical issue is that the EU solvency margin requirements are somewhat broad-brush in nature and could be regarded as appropriate only in the context of prudent technical provisions. A change to provisions at fair value will require the whole structure to be renegotiated, which is not a simple matter when 15 (or more) countries are involved.

A move to fair value accounting does, however, present the opportunity for the IAIS, in collaboration with the IAA, to develop an internationally accepted risk-based capital requirement, which could then simply be adopted by the EU.

Another emerging issue is concern about the static nature of most capital and surplus, or solvency margin, requirements, even if appropriately risk-based in nature. For the future, it seems likely that more emphasis will be placed on dynamic modelling approaches, known variously as financial condition reporting, stress-testing, dynamic financial analysis, dynamic solvency testing or dynamic capital adequacy testing. This will encourage insurance company managements to address risk management issues, will alert management and supervisors to emerging risk situations and will open up more of a dialogue on the factors which could impact adversely on the company in future.

A consequence of a move to greater reliance on financial condition reporting, whether based

on stochastic or deterministic models, is that it could propel the actuary into a more active interaction with senior management and the company Board of Directors. Whether or not this is accompanied by the formalising of an appointed actuary role more widely in general insurance, it seems likely that trends in insurance supervision will place increasing reliance on the professional input of actuaries.

Future developments in the UK

Clearly these international trends can be expected to have an impact on insurance supervision in the UK. Another important factor in the UK is the concentration of supervisory activity for most types of financial institution (other than occupational pension plans) in the Financial Services Authority (FSA) and the absorption of the function of actuarial advice in respect of insurance supervision, previously in the Government Actuary's Department, into FSA from the end of April 2001.

FSA is not a government department or public agency, although it will operate under the terms of a statute (Financial Services and Markets Act 2000 – FSMA2000). It has explicit requirements to focus on the interests of the consumer, as well as maintaining confidence in the financial system.

The FSA intends to implement a common approach to the prudential (ie solvency) regulation of banks, insurers and other financial institutions. In practice this is likely to result in a more formalised risk-based approach to supervision which will focus resources on entities which have greater potential for causing disruption to markets if they get into difficulty. In addition, it is likely that more resources will be devoted to monitoring companies' internal controls, and to reviewing their own internal capital adequacy assessments. This reflects the banking regulators' practice of placing reliance on bank's own internal risk-based capital (RBC) assessments, once these assessments have been reviewed and are considered adequate.

This approach is reflected in the FSA's approach to the future regulation of Lloyd's. Broadly, the FSA propose to place reliance on Lloyd's RBC model once it has satisfied itself that the Lloyd's model is adequate. In addition the FSA has taken powers in the Financial Services and Markets Act so that Lloyd's can be required to exercise its powers under the FSA's direction. The relationship between Lloyd's regulators and the FSA can be expected to be similar to that between an internal and external auditor. The greater the competence of the internal regulators the more reliance the external regulator will be able to place on the control they exercise.

For companies in general, there will be a change of emphasis, with the insurance company now having to convince the regulator that its capital is sufficient. This will presumably entail some form of dynamic financial analysis in its broadest sense. The gamut of tools ranges from complex RBC and stochastic model offices to adverse scenario stress testing.

The FSMA2000 gives powers to the FSA to require insurance companies (and other financial institutions) to appoint an actuary, either for a particular one-off task or on an ongoing basis. Whilst it does not appear to be the current intention to use this to introduce a full appointed actuary system for general insurance business to parallel what happens in life insurance, there is perhaps a greater willingness to consider moves in this direction, and increasingly to seek actuarial reports on companies which are more marginal in terms of meeting solvency margin requirements and holding adequate technical provisions. These

reports should probably focus more on financial condition, and resilience to future changes, than purely on the current balance sheet position.

Conclusion

Supervision of general insurance companies in the UK has almost 100 years of history. Major changes have affected the industry over that time, particularly in more recent years. The UK continues, however, to rely to a considerable extent on the principle of freedom with publicity for insurance supervision. It is increasingly acknowledged that actuaries have an important part to play in the sound financial management of general insurance companies and in advising the supervisory authorities on monitoring the financial strength of such companies. Over the next few years it seems likely that an IASC standard on accounting for insurance contracts will be agreed, and that this will form the basis of global endorsement of a fair value approach to valuing assets and technical provisions of insurance companies, coupled with widespread adoption of common risk-based capital requirements. It would be surprising if these developments did not result in an increasingly important role for actuaries in general insurance companies, with more and more countries adopting an appointed actuary model (or similar) and reliance on actuaries not only for the evaluation of fair value provisions but also for financial condition reports.

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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS
INSURANCE CORE PRINCIPLES (October 2000)

Principle 1: Organisation of an Insurance Supervisor

The insurance supervisor of a jurisdiction must be organised so that it is able to accomplish its primary task, i.e. to maintain efficient, 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 efficiently in accordance with the Insurance Core Principles. In particular, the insurance supervisor should:

- a. be operationally independent and accountable in the exercising of its functions and powers;
- b. have adequate powers, legal protection and financial resources to perform its functions and exercise its powers;
- c. adopt a clear, transparent and consistent regulatory and supervisory process;
- d. clearly define the responsibility for decision making; and
- e. hire, train and maintain sufficient staff with high professional standards who follow the appropriate standards of confidentiality.

Principle 2: Licensing

Companies wishing to underwrite insurance in the domestic insurance market should be licensed. Where the insurance supervisor has authority to grant a license, the insurance supervisor:

- a. in granting a license, should assess the suitability of owners, directors, and/or senior management, and the soundness of the business plan, which could include pro forma financial statements, a capital plan and projected solvency margins; and
- b. in permitting access to the domestic market, may choose to rely on the work carried out by an insurance supervisor in another jurisdiction if the prudential rules of the two jurisdictions are broadly equivalent.

Principle 3: Changes in Control

The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs. These may be the same as, or similar to, the requirements which apply in granting a license. In particular, the insurance supervisor should:

- a. require the purchaser or the licensed insurance company to provide notification of the change in control and/or seek approval of the proposed change; and

- b. establish criteria to assess the appropriateness of the change, which could include the assessment of the suitability of the new owners as well as any new directors and senior managers, and the soundness of any new business plan.

Principle 4: Corporate Governance

It is desirable that standards be established in the jurisdictions which deal with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the insurance supervisor should set requirements with respect to:

- a. the roles and responsibilities of the board of directors;
- b. reliance on other supervisors for companies licensed in another jurisdiction; and
- c. the distinction between the standards to be met by companies incorporated in his jurisdiction and branch operations of companies incorporated in another jurisdiction.

Principle 5: Internal Controls

The insurance supervisor should be able to:

- a. review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary; and
- b. require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management.

Principle 6: Assets

Standards should be established with respect to the assets of companies licensed to operate in the jurisdiction. Where insurance supervisors have the authority to establish the standards, these should apply at least to an amount of assets equal to the total of the technical provisions, and should address:

- a. diversification by type;
- b. any limits, or restrictions, on the amount that may be held in financial instruments, property, and receivables;
- c. the basis for valuing assets which are included in the financial reports;
- d. the safekeeping of assets;
- e. appropriate matching of assets and liabilities, and
- f. liquidity.

Principle 7: Liabilities

Insurance supervisors should establish standards with respect to the liabilities of companies licensed to operate in their jurisdiction. In developing the standards, the insurance supervisor should consider:

- a. what is to be included as a liability of the company, for example, claims incurred but not paid, claims incurred but not reported, amounts owed to others, amounts owed that are in dispute, premiums received in advance, as well as the provision for policy liabilities or technical provisions that may be set by an actuary;
- b. the standards for establishing policy liabilities or technical provisions; and
- c. the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements with a given reinsurer, making provision for the ultimate collectability.

Principle 8: Capital Adequacy and Solvency

The requirements regarding the capital to be maintained by companies which are licensed, or seek a licence, in the jurisdiction should be clearly defined and should address the minimum levels of capital or the levels of deposits that should be maintained. Capital adequacy requirements should reflect the size, complexity, and business risks of the company in the jurisdiction.

Principle 9: Derivatives and "off-balance sheet" items

The insurance supervisor should be able to set requirements with respect to the use of financial instruments that may not form a part of the financial report of a company licensed in the jurisdiction. In setting these requirements, the insurance supervisor should address:

- a. restrictions in the use of derivatives and other off-balance sheet items;
- b. disclosure requirements for derivatives and other off-balance sheet items; and
- c. the establishment of adequate internal controls and monitoring of derivative positions.

Principle 10: Reinsurance

Insurance companies use reinsurance as a means of risk containment. The insurance supervisor must be able to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them.

The insurance supervisor should set requirements with respect to reinsurance contracts or reinsurance companies addressing:

- a. the amount of the credit taken for reinsurance ceded. The amount of credit taken should reflect an assessment of the ultimate collectability of the reinsurance recoverables and may take into account the supervisory control over the reinsurer; and
- b. the amount of reliance placed on the insurance supervisor of the reinsurance business of a company which is incorporated in another jurisdiction.

Principle 11: Market Conduct

Insurance supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with their customers.

Insurers and intermediaries should:

- a. at all times act honestly and in a straightforward manner;
- b. act with due skill, care and diligence in conducting their business activities;
- c. conduct their business and organise their affairs with prudence;
- d. pay due regard to the information needs of their customers and treat them fairly;
- e. seek from their customers information which might reasonably be expected before giving advice or concluding a contract;
- f. avoid conflicts of interest;
- g. deal with their regulators in an open and cooperative way;
- h. support a system of complaints handling where applicable; and
- i. organise and control their affairs effectively.

Principle 12: Financial Reporting

It is important that insurance supervisors get the information they need to properly form an opinion on the financial strength of the operations of each insurance company in their jurisdiction. The information needed to carry out this review and analysis is obtained from the financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on-site inspections and communication with actuaries and external auditors.

A process should be established for:

- a. setting the scope and frequency of reports requested and received from all companies licensed in the jurisdiction, including financial reports, statistical reports, actuarial reports and other information;
- b. setting the accounting requirements for the preparation of financial reports in the jurisdiction;

- c. ensuring that external audits of insurance companies operating in the jurisdiction are acceptable; and
- d. setting the standards for the establishment of technical provisions or policy and other liabilities to be included in the financial reports in the jurisdiction.

In so doing a distinction may be made:

- a. between the standards that apply to reports and calculations prepared for disclosure to policyholders and investors, and those prepared for the insurance supervisor; and
- b. between the financial reports and calculations prepared for companies incorporated in the jurisdiction, and branch operations of companies incorporated in another jurisdiction.

Principle 13: On-site Inspection

The insurance supervisor should be able to:

- a. carry out on-site inspections to review the business and affairs of the company, including the inspection of books, records, accounts, and other documents. This may be limited to the operation of the company in the jurisdiction or, subject to the agreement of the respective supervisors, include other jurisdictions in which the company operates; and
- b. request and receive any information from companies licensed in its jurisdiction, whether this information be specific to a company or be requested of all companies.

Principle 14: Sanctions

Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The insurance supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered. The legislation should set out the powers available to the insurance supervisor and may include:

- a. the power to restrict the business activities of a company, for example, by withholding approval for new activities or acquisitions;
- b. the power to direct a company to stop practices that are unsafe or unsound, or to take action to remedy an unsafe or unsound business practice; and
- c. the option to invoke other sanctions on a company or its business operation in the jurisdiction, for example, by revoking the licence of a company or imposing remedial measures where a company violates the insurance laws of the jurisdiction.

Principle 15: Cross-border Business Operations

Insurance companies are becoming increasingly international in scope, establishing branches and subsidiaries outside their home jurisdiction and sometimes conducting cross-border business on a services basis only. The insurance supervisor should ensure that;

- a. no foreign insurance establishment escapes supervision;
- b. all insurance establishments of international insurance groups and international insurers are subject to effective supervision;
- c. the creation of a cross-border insurance establishment is subject to consultation between host and home supervisors; and
- d. foreign insurers providing insurance cover on a cross-border services basis are subject to effective supervision.

Principle 16: Coordination and Cooperation

Increasingly, insurance supervisors liaise with each other to ensure that each is aware of the other's concerns with respect to an insurance company that operates in more than one jurisdiction either directly or through a separate corporate entity.

In order to share relevant information with other insurance supervisors, adequate and effective communications should be developed and maintained.

In developing or implementing a regulatory framework, consideration should be given to whether the insurance supervisor:

- a. is able to enter into an agreement or understanding with any other supervisor both in other jurisdictions and in other sectors of the industry (i.e. insurance, banking or securities) to share information or otherwise work together;
- b. is permitted to share information, or otherwise work together, with an insurance supervisor in another jurisdiction. This may be limited to insurance supervisors who have agreed, and are legally able, to treat the information as confidential;
- c. should be informed of findings of investigations where power to investigate fraud, money laundering, and other such activities rests with a body other than the insurance supervisor; and
- d. is permitted to set out the types of information and the basis on which information obtained by the insurance supervisor may be shared.

Principle 17: Confidentiality

All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections.

The insurance supervisor is required to hold confidential any information received from other insurance supervisors, except where constrained by law or in situations where the insurance supervisor who provided the information provides authorisation for its release.

Jurisdictions whose confidentiality requirements continue to constrain or prevent the sharing of information for supervisory purposes with insurance supervisors in other jurisdictions, and jurisdictions where information received from another insurance supervisor cannot be kept confidential, are urged to review their requirements.