Directors' School for Insurers in Costa Rica

Topic 3

The Evolution of Insurance Supervision

+ Considerations of Related Party Transactions

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SUGESE
Superintendencia General de Seguros
República de Costa Rica

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Global Leadership in Financial Supervision

The Evolution of Insurance Supervision

Changes currently underway in Costa Rica are representative of changes that are taking place world-wide.

CHECK: On Wednesday, SSRP will discuss developments in insurance supervision in Costa Rica.

The Evolution of Insurance Supervision

The following are typical of changes being implemented by many supervisory agencies:

- **Risk based approach to supervision**
- **Focus on assessment of institutions' risk management systems and quality of their corporate governance**
- **Greater supervisory reliance on input of independent professionals**
- **More frequent use of principles, further explained and illustrated in guidelines, as opposed to detailed rules.**

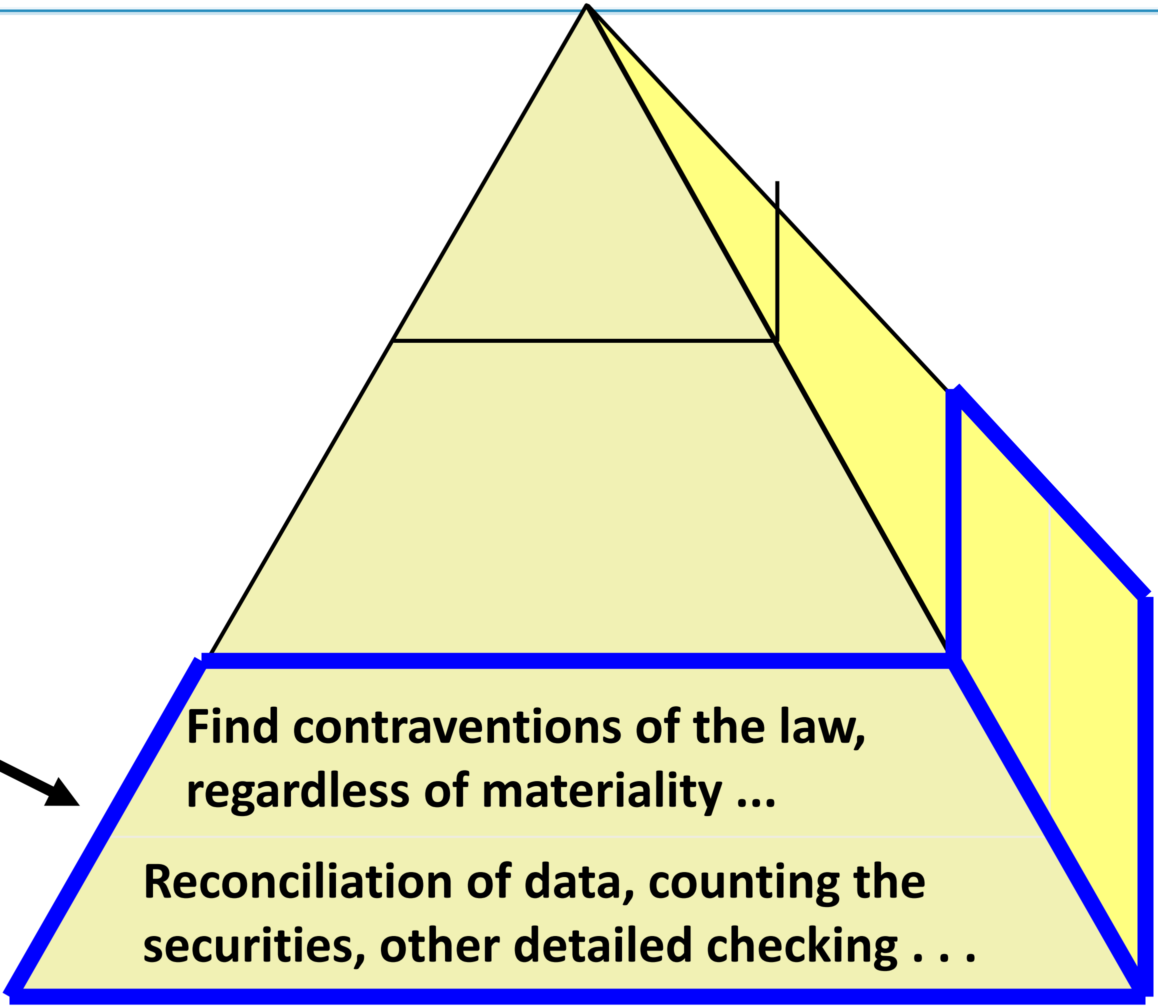
The Evolution of Insurance Supervision

Each of these approaches has developed in response to findings in other jurisdictions and by their gradual incorporation into international standards as adopted by the International Association of Insurance Supervisors, of which Costa Rica is a member.

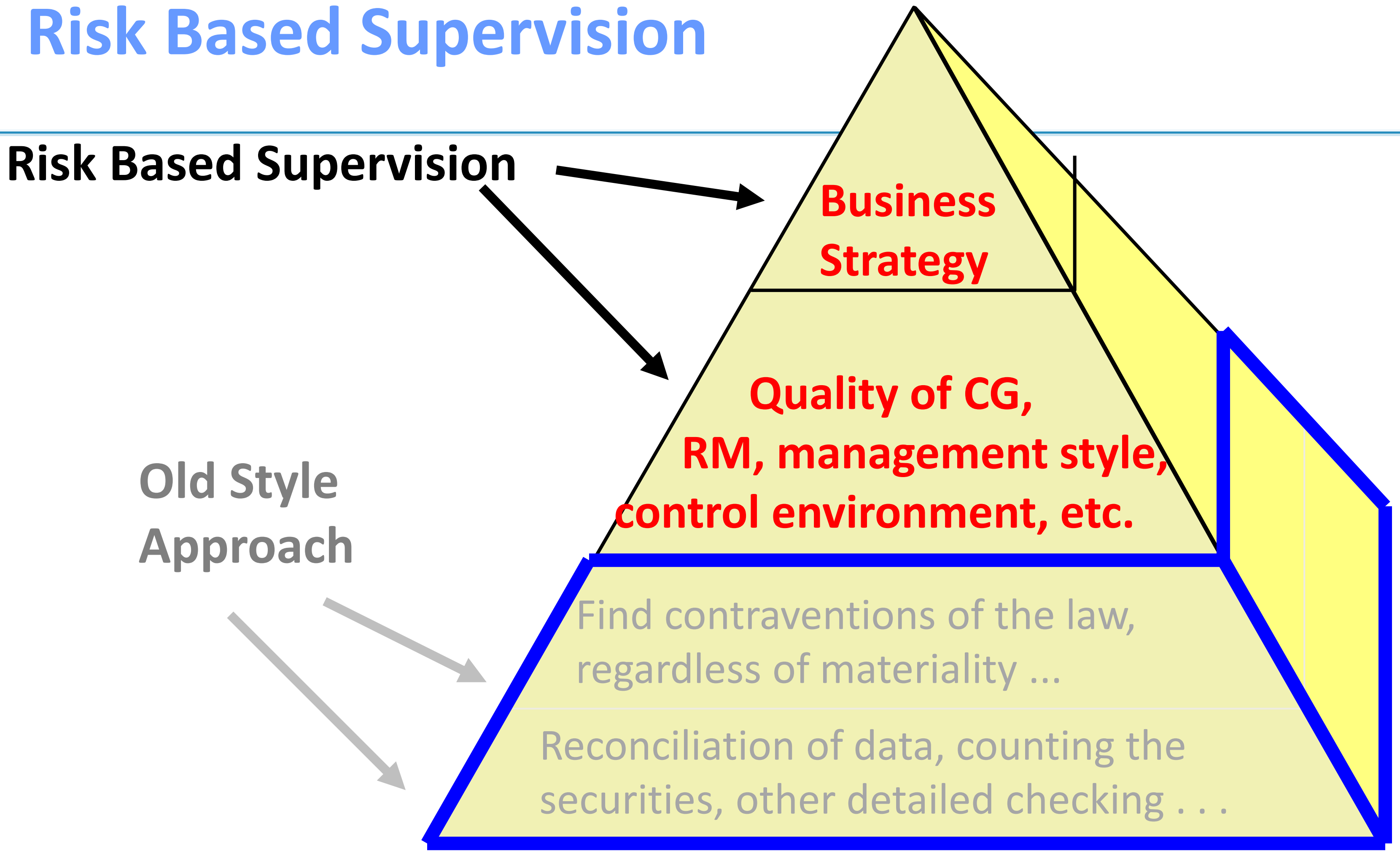
Let's take a look at each area in more detail.

Risk Based Supervision

Old Style Approach

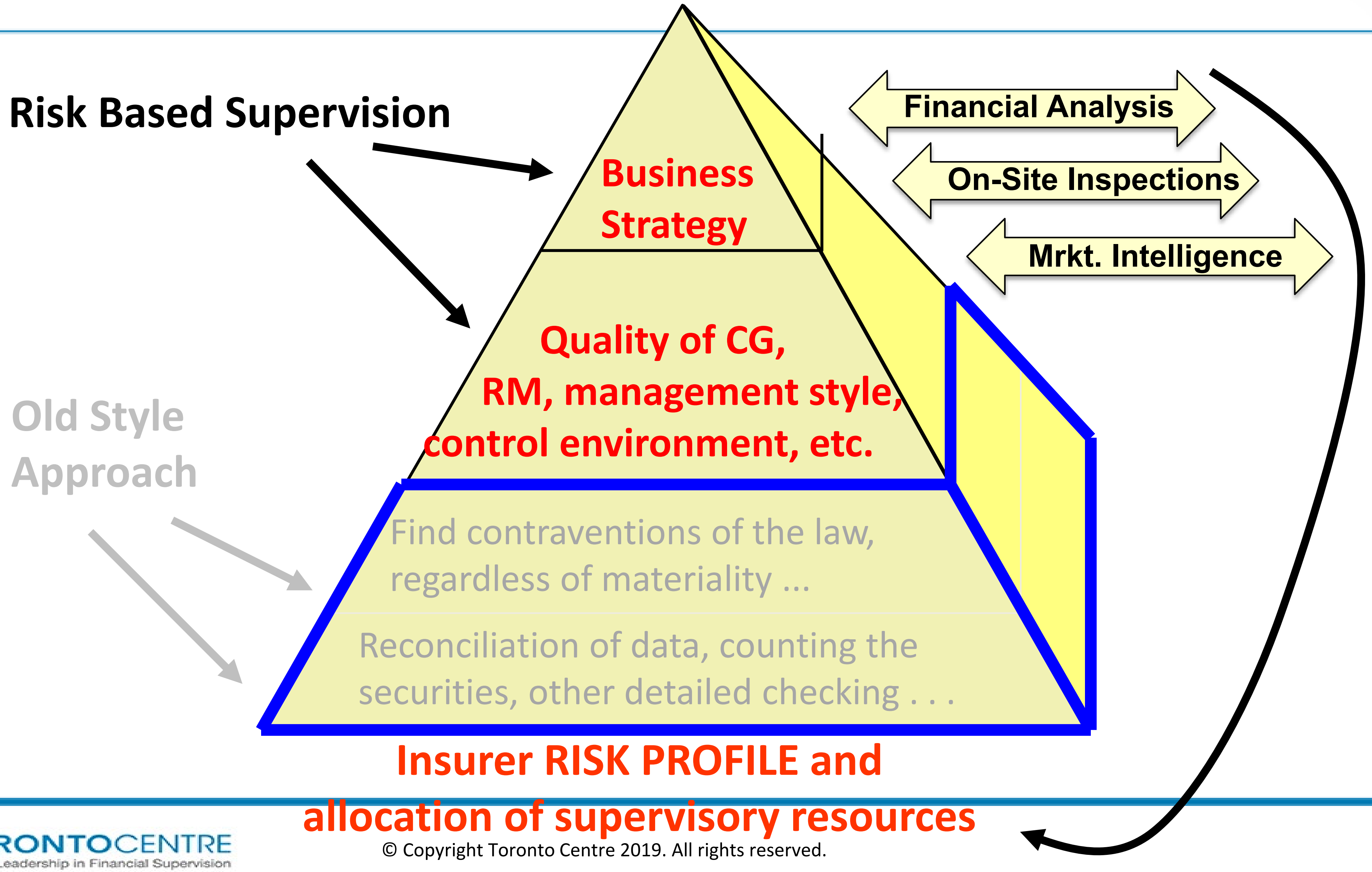


Risk Based Supervision



Today the supervisor is concerned with assessing risk in the company's business operations, the effectiveness of the institution's risk management systems – and ways in which the supervisor can require risk to be reduced when necessary.

Risk Based Supervision



Risk Based Supervision

- Insurance supervisors focus their resources on the highest risk situations.

- They develop methods for assessing risk in insurers in a consistent, objective manner.

- They work to reduce risk of problems occurring rather than attempting to deal with problems after they have happened.

- Insurers should also be aware of how the risk based framework works and understand the supervisory actions that will typically be associated with different levels of risk.

Guide to Intervention – A Public Document

- **A tabular basis for describing different risk levels of supervised institutions, and for each risk level, the general type of supervisory response.**

- **As the risk level increases, so too does the forcefulness of supervisory intervention:**

Risk Level	**Description** **With examples at each risk level**	**Supervisory Response** **With examples at each risk level**
5	**Exit from market**	
4	**Unacceptable Risk**	↑
3	**Moderate Risk**	**Increasing**
2	**Emerging Risk**	**Strength**
1	**Low Risk: normal operations.**	

A detailed Guide to Intervention should be on the supervisor's web site.

Overview of Risk Assessment Process

SIGNIFICANT ACTIVITIES

Various Business Risks[1.] | **offset by** | **Quality of Risk Mitigation Processes**

Asset Risk
- Credit Risk
- Market Risk
- Liquidity Risk

Liability Risk
- Underwriting Risk
- Technical Provision Risk

Operational/Technological Risk

Contagion and Related Party Risk

- Corp Governance/Board
- Senior Management
- Financial
- Internal Audit
- Risk Management

1. General insurance company example

Overview of Risk Assessment Process

After considering the aggregate riskiness of the inherent risk areas, tempered by the quality of risk management, we are left with the NET RISK of the company.

Various Business Risks[1] → **offset by** → **Quality of Risk Mitigation Processes** → **= Net Risk**

Asset Risk
- **Credit Risk**
- **Market Risk**
- **Liquidity Risk**

Liability Risk
- **Underwriting Risk**
- **Technical Provision Risk**

Operational/Technological Risk
Contagion and Related Party Risk

Corporate Governance

Internal Control

Risk Management

Operational Management

Overview of Risk Assessment Process

Net Risk — **Adjusted to take account of current financial strength and quality of earnings** **=** **Composite Risk Rating**

Overview of Risk Assessment Process

How will supervisors actually make these risk assessments?

Benchmarks are established in two main ways:

1. **internationally accepted financial ratios for insurers provide us with measures of risk**

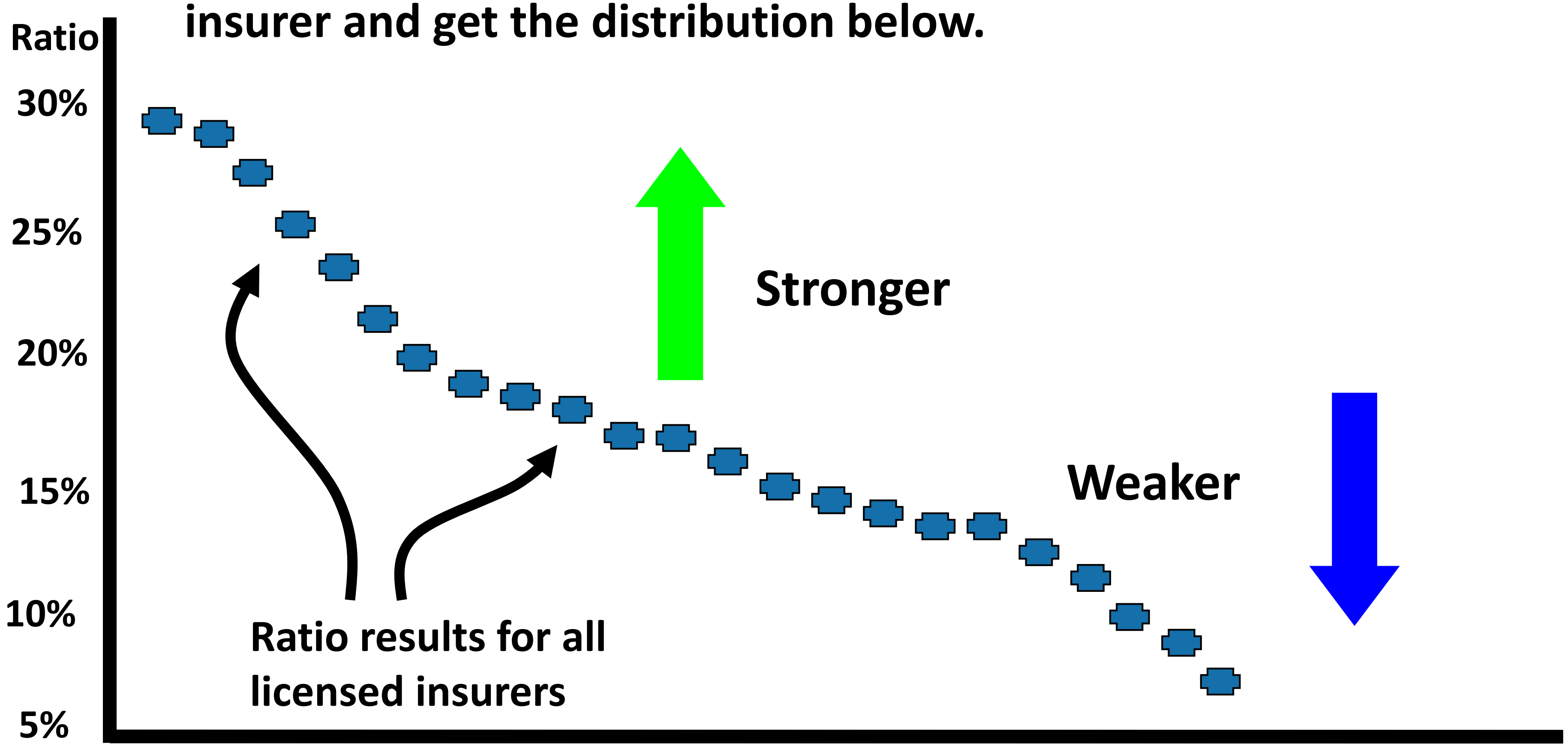
and

2. **risk is assessed directly based on on-site inspections and compliance record of the insurer.**

These are the same methods used by international rating agencies. The process is transparent, consistent and as objective as possible.

Financial Ratios in Risk Assessment

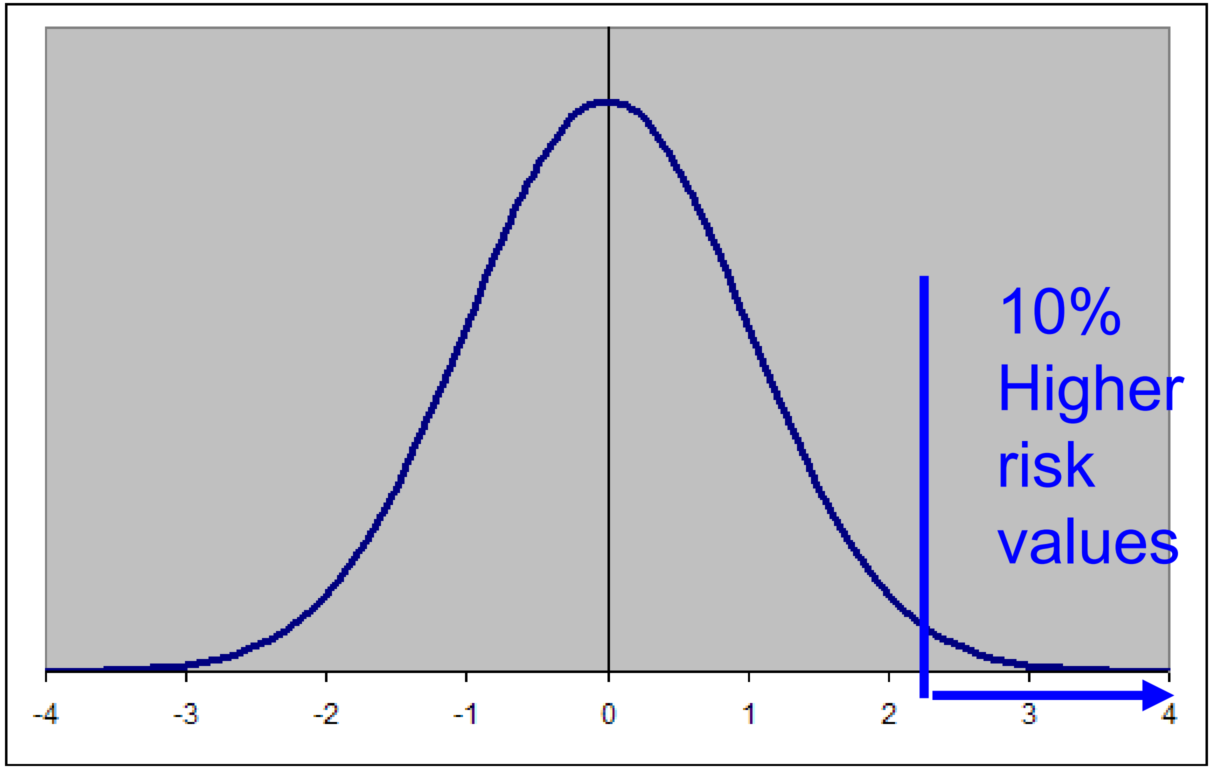
Financial ratios are considered on a relative basis when assessing risk. So let's suppose we calculate a hypothetical ratio for every licensed insurer and get the distribution below.



Financial Ratios in Risk Assessment

For each ratio we can consider a particular range to be indicative of higher risk.

For example, in the case below, we consider the highest 10% of values to be outside of what we will call "the normal range" for the ratio



Financial Ratios in Risk Assessment

An Excel spreadsheet can be generated with the ratios. Using a simple formula each result is checked for “within normal range” or “outside range”, with the latter being flagged by the software.

Insurer

of Test Results to Classify for "HI RISK" Based on Financial Ratios						"HI RISK" if > "X" tests Outside Range	Enter "x" here ↓
PLAN	Ratio 1	Ratio 2	Ratio 3	Ratio 4	# OF TESTs "NOT OK"	"X" =	3
A	OK	OK	OK	OK	0	OK	
B	OK	OK	OK	Outside Range	1	OK	
C	OK	OK	OK	OK	0	OK	
D	Outside Range	OK	Outside Range	Outside Range	3	HI RISK	
E	OK	OK	OK	OK	0	OK	
F	OK	OK	Outside Range	OK	1	OK	
G	OK	OK	OK	OK	0	OK	
H	OK	Outside Range	OK	OK	1	OK	
etc					# of Hi Risk =	1	

So for this group of insurers, although there are several companies with ratios falling into the “outside of normal range” category, the insurer itself only attracts a “hi risk” rating if it has 3 our more ratios ranked as high risk. Only 1 company meets this test for “High Risk”

Principles Based Approach

Modern supervisory systems are to an increasing extent, adopting a "principle based" approach.

The laws and guidelines are formulated in a way that describe the results to be achieved, as opposed to stipulating a lot of detailed rules (which the rule-makers believe will lead to the desired results, aka a rule-based approach).

With rule-based approach:

- **Assumption is that rule-makers know best how to achieve goal.**
- **Financial landscape changes rapidly, but rules do not.**
- **Rules encourage "loop-hole seeking", principles do not.**

Principles Based Approach

As an example of how a system may go from a rule based to a principle based approach, consider the transition that has taken place in Canada with the investment provisions in the law.

- **Rule based approach: Detailed rules spell out financial standards for "eligible" investments in common shares. There were many rules related to "eligible" investments. One was, shares must have paid dividend in 4 of last 5 years of at least 4% of their value in the capital account of the company, in order for an insurer to purchase.**

- **So basically only "blue chip" common shares will qualify for purchase by insurers.**

Principles Based Approach

But . . .

- **Law firms purchase personal corporations from retiring dentists and doctors. Of course these tiny companies have paid significant dividends over the years and therefore meet the Insurance Act requirement.**

- **Law firm recapitalizes the dentist's corporation with say $50 million, arranges for it to take over an existing corporation, and suddenly you have the dividend stream that provided income to the dentist, being used to qualify the purchase by an insurance company of shares in some huge new undertaking. The rules have been completely subverted from what was intended, but it's all legal.**

Principles Based Approach

There were many other examples as well. Over time the investment rules became pretty much irrelevant as so many loop-holes had been devised.

Today in Canada the Insurance Act simply states that:

492. The directors of a company shall establish and the company shall adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return.

Principles Based Approach

- The policy is to be established by the board.
- The directors operate under a duty of care enshrined in the law, which extends to the interests of all key stakeholders (i.e. including customers) in carrying out their responsibilities as directors.
- Supervisors will advise the board if they are of the view that the policy is not appropriate and that it requires modification.

This approach allows each company to tailor an investment policy that is best suited to matching its unique portfolio of liabilities as well as its risk appetite as has been defined by the board – it is not "one size fits all".

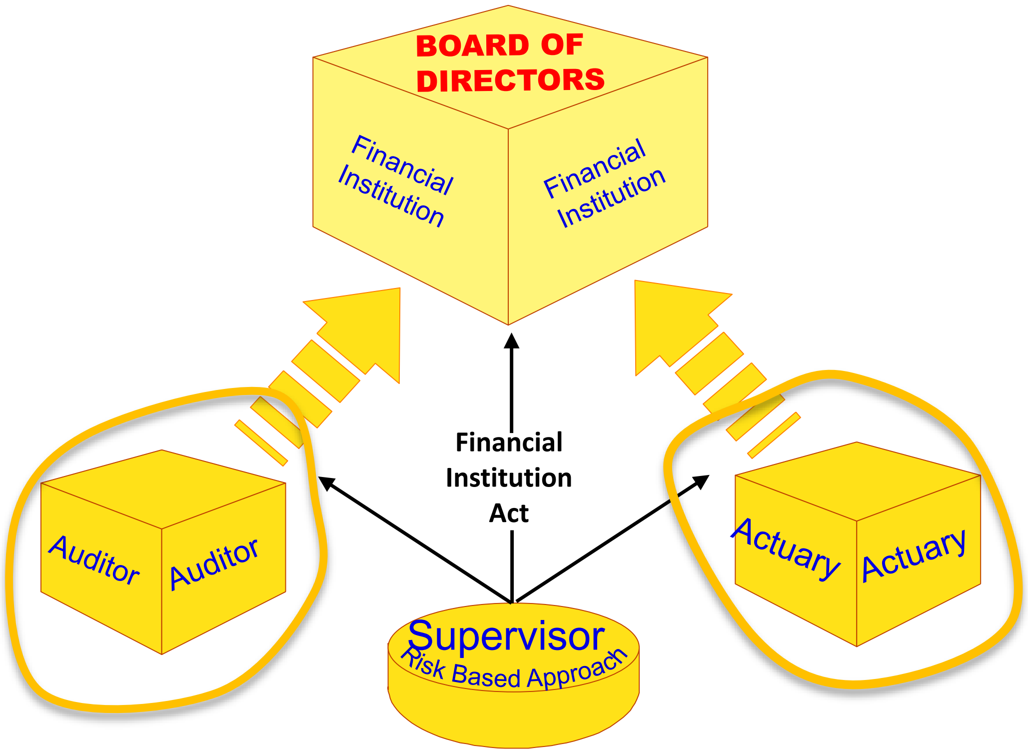
Principles Based Approach

We need to move away from a strictly rule-book mentality, avoiding the creation of yet more paperwork and bureaucracy and in its place, we can work with our regulators to develop and require adoption of ethical principles of behavior. In the end, this kind of collaborative approach may be more helpful than an onslaught of new rules. Rules generate loopholes, and loopholes lead to malfeasance. But if introducing more rules won't work, developing principles of behaviour just might, especially if backed by clear guidance to minimize compliance costs."

Lloyd's Chairman Peter Levene
April 18, 2005

Reliance on Independent Professionals

We recognize that regulator can't know and do everything, so the law places greater responsibility on independent auditor and actuary for providing assessments and other material that will be relied upon by the supervisor.



Over time, this also benefits the professional development of auditors and actuaries, which in turn can be beneficial to the entire economy.

Supervisory agency closely collaborates with these professionals, for example, meeting with auditor and reviewing working papers prior to on-site examination.

A Modern Supervisory Framework

The Insurance Law

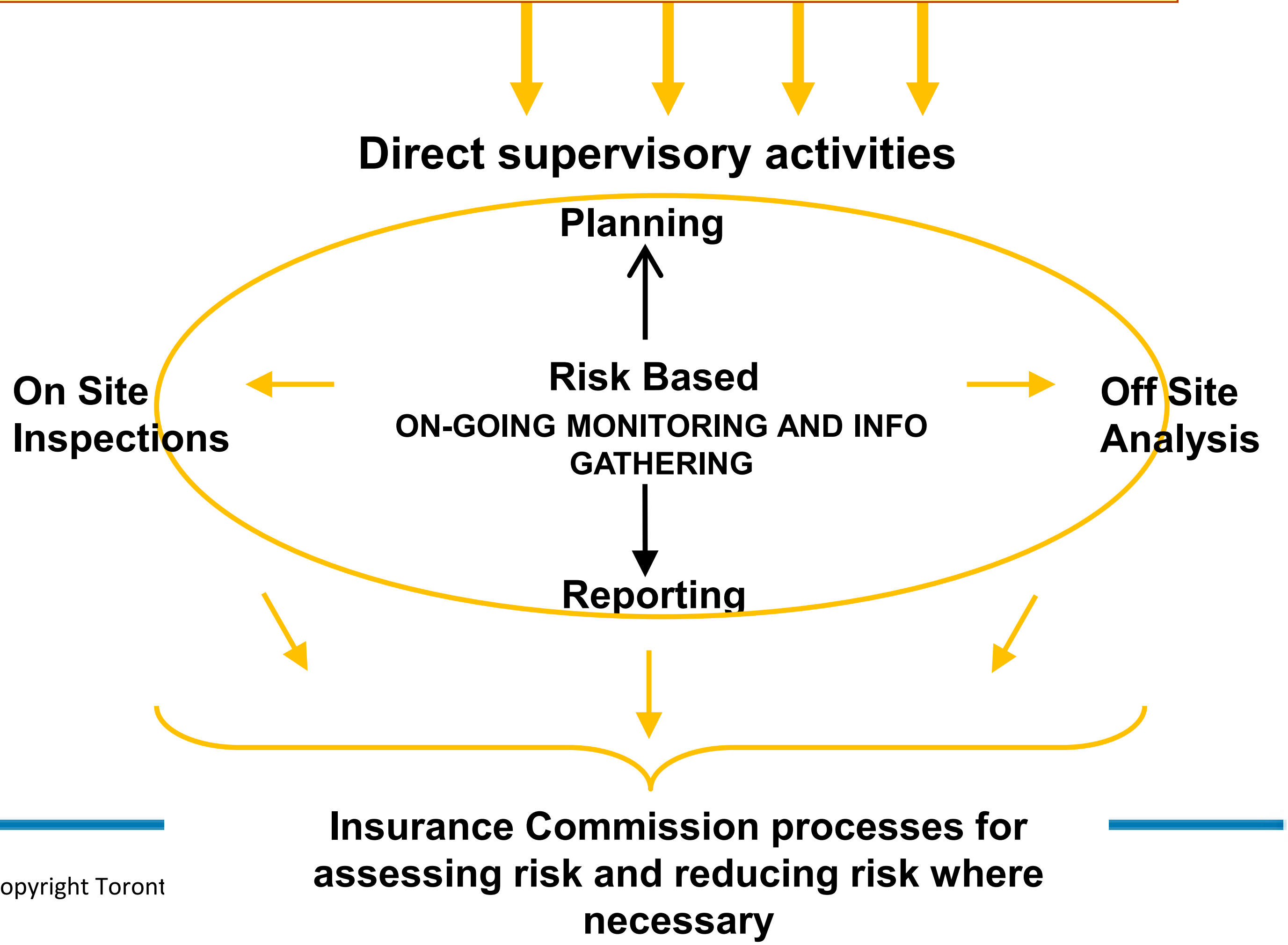
Policies and Procedures of the Insurance Supervisory Agency

Direct supervisory activities

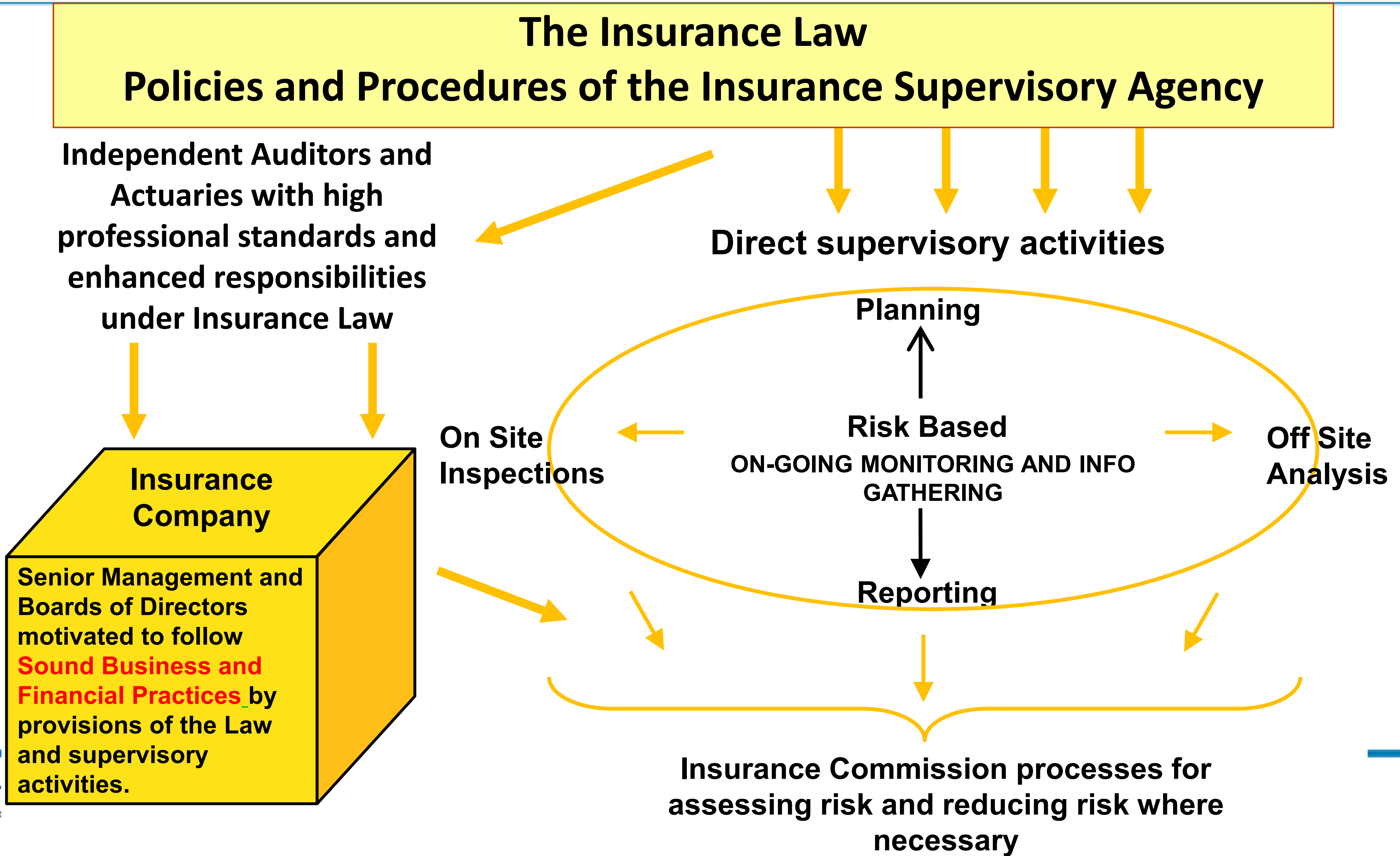
A Modern Supervisory Framework

The Insurance Law

Policies and Procedures of the Insurance Supervisory Agency



A Modern Supervisory Framework



A Modern Supervisory Framework

- As we see, key principles of corporate governance can be enshrined in the law with additional detail by means of regulatory guidelines.

- However . . .

“No law can prevent bad judgment or stop all criminal acts. In the public and private sectors alike, the ability to earn trust depends utterly on the moral compass of those at the helm. Good governance, in the end, is not a set of rules but rather an expression of values.”

“GOVERNANCE, VALUES AND COMPETITIVENESS”, A Study by the Canadian Council of CEO’s

A Modern Supervisory Framework

Traditional Approach to Supervision	Modern Approach to Supervision
Many detailed rules constrain company options	Less detailed, less intrusive, less "rule oriented"
Supervisor's objective is to find financial problems	Supervisor's objective is to avoid financial problems
Supervisor must ensure compliance	Company (Board, Management, internal controls, RM) mainly responsible for compliance
Supervisory responses difficult to predict, sometimes not consistent	Transparent processes: risk assessment and expected supervisory responses based on established framework, e.g. Guide to Intervention

A Modern Supervisory Framework

Traditional Approach to Supervision	Modern Approach to Supervision
Many requirements for supervisory approval, e.g. policy forms, reinsurance contracts	Board and senior management approve but supervisor can require modification
Many activities are not risk based, e.g. all licences renewed annually, companies reviewed in alphabetical order	Activities risk based, e.g. licence can be modified anytime if risk too high

Basic Powers of Supervisors

When risk based assessments have been made, the onus is on the insurer to take steps to reduce risk where considered necessary by the supervisor.

What powers can supervisors typically apply if an insurer does not take effective measures to reduce risk?

Basic Powers of Supervisors

1. On-Site Inspections: with a risk based approach, the lower your risk, the less you see of the supervisory staff.

- Review of financial data provides a look into the past – but on-site inspection is a real-time assessment of what is happening.
- On-site also enables supervisory staff to discuss current issues with management; how are challenges being addressed:
    - what are the company's plans for the future?
    - how will those plans impact the company's risk profile?

Depending on the time and resources allocated by the supervisor, the on-site inspection can be an effective power in terms of persuading insurers to initiate appropriate measures to reduce risk.

Basic Powers of Supervisors

2. Review of Insurer Business Plans

- **The business plan is a critically important piece of information that the supervisor must be able to review. Why?**
  - **Provides insight as to risks that might emerge in future periods**
  - **Base case to monitor over time and ensure plan is 'on track'**
  - **Quality of plan tells much about depth, quality of management**

Basic Powers of Supervisors

3. Minimum solvency requirements that can be adjusted to take account of company circumstances, i.e. risk level.

- **A licence to transact business is a privilege, not a right.**
- **The licence is subject to maintaining adequate levels of capital to support the business.**
  - **Policyholders are only paying for one thing: security.**
  - **Real security is only provided by financially sound insurers.**

Basic Powers of Supervisors

4. Power to withdraw the licence.

- **By the time the licence is being withdrawn, the time for constructive action has actually expired.**

- **However, having the ability to withdraw the licence does provide the supervisor with considerable leverage.**

Basic Powers of Supervisors

5. Power to impose sanctions and fines.

- Must be sufficient to motivate compliance.
- Must be imposed when there are significant instances of non-compliance
- Directors and officers should be exposed to major penalty if they do not do what they can to ensure that their companies follow sound business and financial practices as defined in the law. (This relates to the “duty of care” that is frequently contained in the law.)
- In some jurisdictions, a director can only avoid liability for an illegal motion at the board level, by voting against it.

Basic Powers of Supervisors

6. Power to impose licence conditions and undertakings.

- **This is one of the most powerful measures available to the supervisor.**
- **When emerging risks are clear, specific limitations can be imposed by means of a licence condition, or required through an undertaking.**

Example: Overly rapid growth is a frequent cause of financial instability. A licence condition can restrict the company to a specific future volume of premium or ratio of net premiums to equity, limiting risk.

- **Non-compliance with an undertaking or licence condition constitutes a contravention of the law.**

Undertaking Example

- An insurer is investing in stocks that are recommended by a sister brokerage firm, driving up the price. The brokerage firm calls many prospective buyers, pointing to the rising price. Lots more shares are sold. Then the insurer dumps its position, taking a profit and having generated big commissions for the related party brokerage firm. Other investors are left holding the bag – and big losses.

    - The insurer is required to sign an undertaking prohibiting it from investing in or otherwise dealing with, directly or indirectly, any securities being promoted or otherwise related to the brokerage firm or other related party.

License condition examples

- An insurer specializing in Motorcycle insurance has a condition inserted in its certificate of registration:
  - "the company is authorized to underwrite business in Canada and the United States, subject to the condition that its gross premium written in the United States in any consecutive 12 month period, may not exceed ten percent of its gross premium written in Canada during the same 12 month period."
- A particular product of a particular insurer has given rise to many complaints with regard to a lack of transparency, and the company has not improved the product, so:
  - "the company is authorized to underwrite group creditor life insurance business, subject to the condition that in the sale of its policies it will provide clients and prospective clients with a product disclosure statement approved by the supervisory authority."

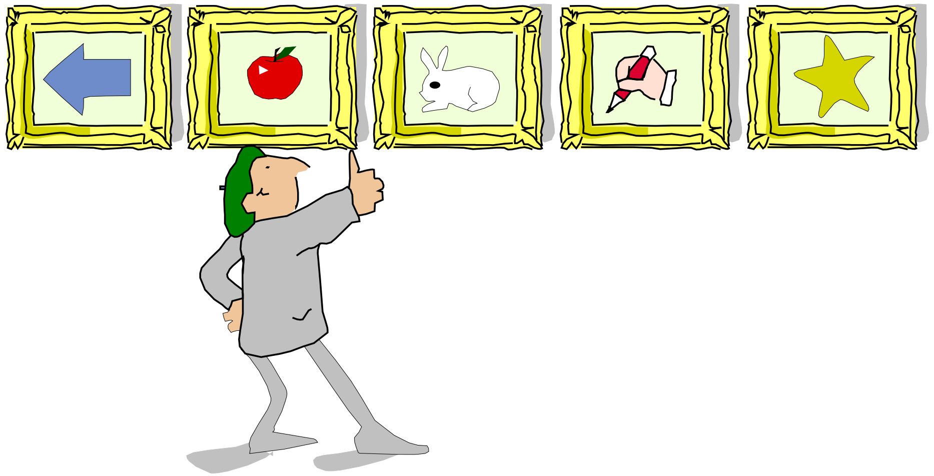
Basic Powers of Supervisors

7. Special investigation with costs to insurer.

- Supervisors don't have the resources available to insurers, especially in smaller and emerging markets.
- Therefore the supervisor should have the power to retain professional advisors, and cost may be charged to the insurer.
- This power levels the playing field and enables the supervisor to challenge insurers who routinely have access to professional advisors.

8. Power to adjust asset and liability values for purposes of capital determination.

- Over-valuation of assets, under valuation of liabilities are ways of evading the solvency requirement and masking a weak capital position.
- Therefore supervisor has authority to obtain professional valuations, which can be substituted for company values when there is evidence of over or under-valuation.
- This does not give rise to disputes with the auditor because it is only for purposes of applying the minimum solvency requirement.



Basic Powers of Supervisors

9. Power to impose a time horizon on the licence.

- When important initiatives need to be taken, but time is passing with no action, a limited time horizon for the licence serves to emphasize that this is an action that MUST be taken.

10. Power to conduct a public hearing.

- Refer to the Li Brothers case for an illustration of the effectiveness of this provision.

Basic Powers of Supervisors

11. Power to require a deposit if it seems to be in the public interest.

- **This power would rarely be used but could be effective if there is evidence that the company's assets might actually disappear. (In the Maple Tree case - to be presented - virtually the entire investment portfolio was required to be placed as a deposit under the control of the supervisor.)**

Note: This is not the same as requiring every insurer to maintain a deposit with the supervisor. The latter is not a risk based approach because a deposit is required from every company, regardless of risk. Plus, a statutory deposit is rarely of sufficient size that it makes any difference to policyholders in the event of insolvency.

Basic Powers of Supervisors

12. A letter of direction.

- **This is more or less the ultimate power, i.e. the power to order a company to change its practices or to alter its operations in any particular way.**
- **A letter of direction may be appealed to a court, but only on the grounds that the direction was in some way improperly constituted, not because of disagreement with the substance of the order.**
- **Non-compliance constitutes "contempt of court" and could be punishable by jail time.**

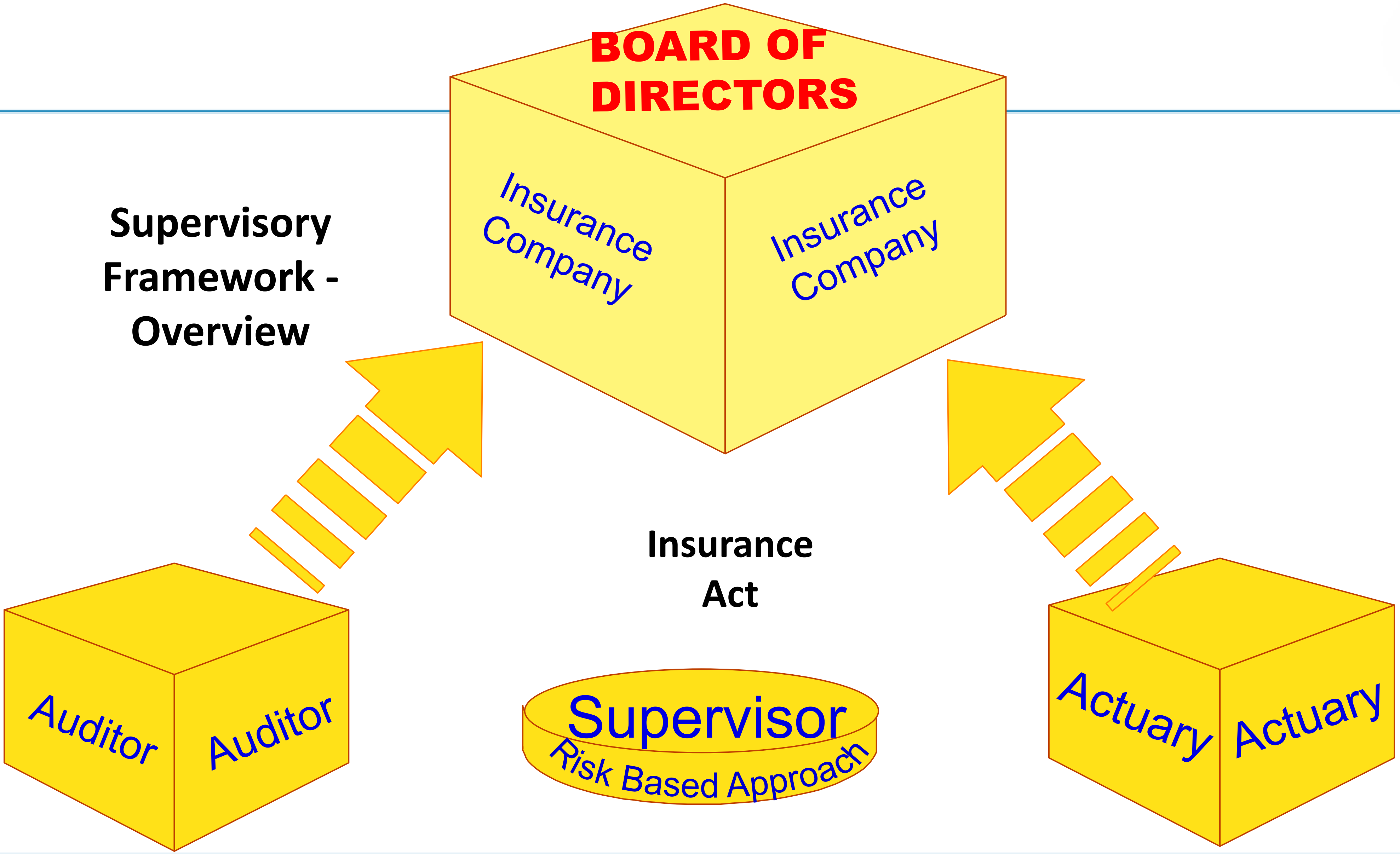
Management and the Board are Key

Experience in many countries has clearly demonstrated that the best way of ensuring a healthy insurance industry is to have well managed insurers with good systems of risk management and corporate governance.

Lowest risk companies are marked not only by having excellent capital strength, but also by sound and experienced management backed up by high performance boards of directors.

Therefore, today's systems of risk based supervision are largely designed to foster good management practices and appropriate levels of board oversight.

Supervisory Framework - Overview



The Board is the Cornerstone of the System

Board

Responsible for overseeing, directing, appointing. Duty to take account of interests of all stakeholders, not just shareholders. Some independent members, and of those, some that are knowledgeable about the business.

The Board is the Cornerstone of the System

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Responsible for overseeing, directing, appointing. Duty to take account of interests of all stakeholders, not just shareholders. Some independent members

Audit Committee

At least 3 members, majority are independent and chair is independent director

The Board is the Cornerstone of the System

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At least 3 members, majority are independent and chair is an independent member

Auditor:
Financial Reporting, Well Being

Management:
Input and advice in all areas, Internal Audit

Actuary:
Valuation, Risk based capital, stress testing

The Board is the Cornerstone of the System

Depending on the size of the insurer, the size of the board and other factors, there could be additional committees that are important, such as a Conduct Review Committee, an Investment Committee, a Risk Committee and so on.

For insurers that are quite small, some or all of these committee responsibilities might be handled at the level of the full board.

Board

Responsible for overseeing, directing appointing. Duty to take account of interests of all stakeholders, not just shareholders. Some independent members

Audit Committee

At least 3 members, majority are independent

Auditor

Financial Reporting, Well Being

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Input and advice in all areas, Internal Audit

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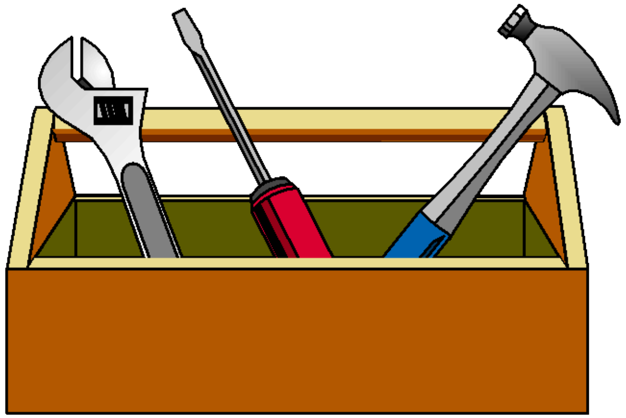
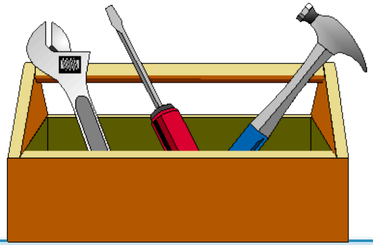
Shop Talk – Related Party Transactions





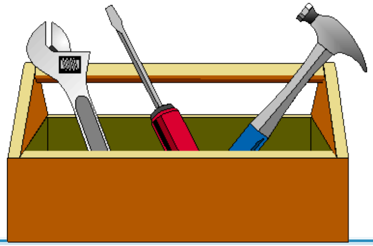
Related Party Transactions

A related party transaction is a transaction between an insurer and a major shareholder, or an entity in which a major shareholder has a significant interest.

Related party transactions are probably the largest single cause of insurance company failures over the years.

Related party transactions are often to the benefit of the shareholders and the detriment of the insurer.

The normal balancing of interests, leading to fairness in negotiations, is missing: the shareholder can fire the CEO or alter the CEO's remuneration package if he or she resists the shareholder's proposed transaction.



Related Party Transactions

Typical related party transactions:

- **related party sells real estate to the insurer at price specified by the related party**
- **insurer makes loan to related party**
- **insurer invests in business or property controlled by related party**
- **insurer makes joint investment with related party in a business venture**
- **reinsurance transactions - favouring the RP reinsurer in an offshore jurisdiction**
- **purchase of services (e.g. management contract) from a related party**

Related Party Transactions

Related party transactions can be controlled by:

- **Complete prohibition – but usually not feasible in less developed countries**
- **Prohibition of *material* Related Party Transactions**
- **Making directors responsible for having policies and procedures in place to minimize the possibility that RPTs will increase the risk profile of the insurer.**

A Conduct Review Committee, having a majority of independent directors and chaired by one of them, can be responsible for ensuring that these controls are respected. (Including maintenance of appropriate documentation used to reach decision.) Committee makes recommendations to the full board.

Related Party Transactions

What policies and procedures might a board adopt to ensure that Related Party Transactions are not contrary to the interests of the insurer?

The board is satisfied that:

1. **The transaction is appropriate for the insurer, having regard to the board's written investment policy and Risk Appetite Statement, as well as the nature and terms of the insurer's liabilities.**

2. **The transaction is at a value that does not exceed market value.**

3. **The proposed transaction is not material relative to the capital base of the insurer. (For example, not more than 5% of capital base.**

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