

A Core Curriculum for Insurance Supervisors

ICP 3: The Supervisory Authority

Basic-level Module



THE WORLD BANK

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About the Core Curriculum

A financially sound insurance sector contributes to economic growth and well-being by supporting the management of risk, allocation of resources, and mobilization of long-term savings. The insurance core principles (ICPs), developed by the International Association of Insurance Supervisors (IAIS), are key international standards relevant for sound financial systems.

Effective implementation of the ICPs requires skilled and knowledgeable insurance supervisors. Recognizing this need, the World Bank and the IAIS partnered in 2002 to develop a “core curriculum” for insurance supervisors. The Core Curriculum Project, funded and supported by various sources, accelerates the learning process of both new and experienced supervisors. The ICPs provide the structure for the core curriculum, which consists of a set of modules that summarize the most relevant aspects of each topic, focus on the practical application of supervisory concepts, and cross-reference existing literature.

The core curriculum is designed to help those studying it to:

- Recognize the risks that arise from insurance operations
- Know the techniques and tools used by private and public sector professionals to identify, measure, and manage these risks
- Operate effectively within a supervisory organization
- Understand the ICPs and other IAIS principles, standards, and guidance
- Recommend techniques and tools to help a particular jurisdiction observe the ICPs and other IAIS principles, standards, and guidance
- Identify the constraints and identify and prioritize supervisory techniques and tools to best manage the existing risks in light of these constraints.

Note to learner

Welcome to the ICP 3: The supervisory authority module. This is a basic-level module on the legal and operational environment of a supervisory authority. It does not require specific prior knowledge of this topic and is intended to provide an understanding of the issues and how they are resolved in this area. The module should be useful to new insurance supervisors interested in understanding the basis for the establishing and operating the supervisory authority so that they may work confidently in such an environment. The module may also be useful for experienced supervisors who have not dealt extensively with the topic, have joined the supervisory authority in a senior role from industry or another government agency, or simply are seeking to refresh and update knowledge.

Start by reviewing the objectives, which will give you an idea of what a person will learn as a result of studying the module, and then proceed to study the module either on an independent, self-study basis or in the context of a seminar or workshop. The amount of time required to study the module on a self-study basis will vary, but it is best addressed over a short period of time, broken into sessions on sections if desired.

To help you engage and involve yourself in the topic, we have interspersed the module with a number of hands-on activities and questions for you to complete. These are intended to provide a checkpoint from time to time so that you can absorb and understand the material more readily and can apply the material to your local circumstances. You are encouraged to complete each of these activities before proceeding with the next section of the module. An answer key in Appendix III sets out some of the points that you might consider when responding to the questions. If you are working with others on this module, develop the answers through discussion and cooperative work methods.

As a result of studying the material in this module, you will be able to do the following:

1. Describe the minimum legal powers necessary for an effective insurance supervisory authority:
 - a. Explain the derivation of those powers
 - b. List the tools an insurance supervisor may need
2. Show how the authority to make regulations (enforceable rules that do not require parliamentary approval) influences the effectiveness of insurance supervision
3. Contrast the supervisor's responsibilities in jurisdictions:
 - a. Where the authority to grant and remove a license resides with the supervisor and
 - b. Where such power is reserved for the minister or other senior government official
4. Identify the essential criteria of an independent supervisory authority and elaborate the policies and procedures that would enable these criteria to be put into practice
5. Explain the potential for conflicts of interest in insurance supervision and recommend appropriate safeguards
6. Describe the characteristics of a transparent and accountable supervisory process
7. Identify the financial resources required for effective insurance supervision:
 - a. Describe the alternative means of financing the supervisory authority
 - b. Illustrate possible consequences of each
8. Categorize the various professional skills required for effective supervision of insurance
9. Enumerate the essential criteria of adequate human resources for insurance supervision

10. Describe an appropriate human resource development plan for a supervisory authority
11. Defend market-based compensation arrangements for professional personnel working in a supervisory authority
12. Compare outsourcing and internal staffing as means of accomplishing supervisory objectives
13. Explain appropriate safeguards in connection with any outsourcing of supervisory functions
14. Describe appropriate safeguards for the protection of confidential information in the possession of a supervisory authority and the external specialists it has hired
15. Summarize the requirements of ICP 3.

ICP 3: The Supervisory Authority

Basic-level Module

A. Introduction

Insurance markets require supervision for the sake of consumer confidence in an essential but complex business that competitive forces do not always regulate adequately. Few people would buy insurance if they were uncertain whether they would receive the benefits promised. Most consumers understand very little of the significance, value, or operation of their insurance contracts until they file a claim. The supervisory authority creates a viable market for insurance contracts by protecting the rights of consumers under those contracts and monitoring the solvency of insurers.

Supervisory authorities may be public or private entities, they may be autonomous institutions or part of the government (a department of the finance ministry, for example), and occasionally they may share supervisory responsibilities with other agencies.¹ Increasingly, insurance regulation is being integrated with regulation of banking, securities, pensions, or other financial services, either through coordinated actions of separate agencies or through combined units.

Whatever the circumstances, the effectiveness of a supervisory authority depends on key attributes recognized in the insurance core principles.² ICP 3 states the supervisory authority:

- Has adequate powers, legal protection, and financial resources to exercise its functions and powers

1. For an example of a private supervisory authority, see the structure of the Financial Services Board of the Republic of South Africa, as described on its website: www.fsb.co.za.

2. An excellent succinct discussion of regulatory effectiveness and the political, legal, and financial backing that enables a regulator to carry out its duties appears in Carmichael and Pomerleano (2002, pp. 48–56).

- Is operationally independent and accountable in the exercising of its functions and powers
- Hires, trains, and maintains sufficient staff with high professional standards
- Treats confidential information appropriately.

The full text of ICP 3, including the explanatory notes and essential and advanced criteria, appears in appendix I. This module discusses each of these attributes and explores their interaction. As the discussion shows, independence, accountability, transparency, and integrity reinforce each other, providing the foundation for effective supervision.

B. Essential purpose of the Supervisory Authority

To manage its responsibilities effectively, a supervisory authority must adhere to its legislated purpose. It should develop a formal mission statement that explains its essential purpose clearly and succinctly, based on its legislated purpose. The mission statement is a broad statement of the objectives of the authority.³ ICP 2 stresses the importance of defining those objectives in the enabling law. The mission statement presents them in a manner that is easy for all stakeholders to understand. Boxes 1 and 2 present two examples. While each defines the scope of the authority's role, their emphasis is somewhat different.

In the constant barrage of demands for action from the industry, government officials, and the general public, supervisory authorities can easily lose sight of the mission and objectives. A clear mission statement helps to maintain consistent application of the laws and regulations and avoid short-term, politically expedient actions that conflict with the underlying purposes. A good practice is to place the mission statement on the office wall as well as on the website and in all publications. Even more important, the mission statement must be the basis on which regulatory priorities are set and be a living part of all that the agency does.

The mission statement guides priorities for the authority. Supervisory resources are limited and should be directed toward activities that clearly fall within the scope of the mission. Before taking action, employees should first consider the intent of the mission statement.

A formal statement also helps to make policies consistent with the mission. The policies of the authority are subordinate to the mission, so any policy that would conflict with it must be reconsidered.

By announcing the broad "public interest" standards of the authority, the mission statement sets the tone for the agency's interactions with the industry and the public.

Finally, the mission statement provides justification for actions. A clear mandate makes it easier to measure the agency's performance against that mandate. A public mission statement protects the supervisory authority against claims by politicians and by the supervised institutions that it has not carried out its mandate.

Box 1. Sample Mission Statement: Maine Bureau of Insurance

The Maine Bureau of Insurance is a consumer-oriented regulatory team that functions proactively to promote the best in fair and consistent insurance practices, policies, and laws. We strive to serve the public by understanding the needs of consumers and regulated parties in a dynamic and changing environment. This will be achieved by effective communication, use of modern technology, empowering decisionmaking by Bureau staff, and encouraging professional development. We will respect each other and the public we serve and commit ourselves to developing and maintaining a quality workplace.

3. For a review and restatement of conventional regulatory objectives, see Carmichael and Pomerleano (2002, pp. 21–37).

Box 2. Sample Mission Statement: Australian Prudential Regulation Authority

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. APRA is funded largely by the industries that it supervises. It was established on 1 July 1998. APRA currently supervises institutions holding approximately \$2.0 trillion in assets for 20 million Australian depositors, policyholders, and superannuation fund members.

Our vision: is to be a world-class integrated prudential supervisor recognised for its leadership, professionalism, and innovation.

Our mission: is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient, and competitive financial system.

Our values: are underpinned by the highest standards of individual and corporate integrity, as well as by flexibility, openness, and accountability.

Our supervisory approach: is forward-looking, primarily risk-based, consultative, consistent, and in line with international best practice. This approach also recognises that management and boards of supervised institutions are primarily responsible for financial soundness.

Setting priorities

Priorities must be set for the specific demands that arrive daily, such as applications for certificates of authority, requests for approval of insurance policy forms, requests from the legislature for information, and initiatives that the authority takes to address problems it sees in the market. The mission statement is the starting point for setting priorities.

The authority needs a planning function that evaluates market behavior and performance to identify issues that require attention. That is, what is happening in the market that most threatens the essential purposes of insurance supervision? Such threats may be the result of current economic conditions or may result from the introduction of new products, operating practices, or market opportunities. The authority should establish priorities for initiatives that address current market issues, subject to the availability of adequate resources. Generally, supervisory authorities will have a much longer list of potential initiatives than can be addressed by the available resources. Thus prioritization is essential.

Concerning demands for action, the authority should establish standards of performance consistent with any particular requirements in the laws and regulations. For

Box 3. Example of Service Standards

Canada's Office of the Superintendent of Financial Institutions has established the following standards for services for which a fee is charged:

<i>Service</i>	<i>Proposed service standard</i>
Superintendent deemed approvals	90 percent will be processed in less than 30 calendar days of receipt
Superintendent nondeemed approvals, except those in category 3	90 percent will be processed in less than 60 calendar days of receipt
Superintendent non-deemed approvals of deposit and trust agreements and letters of credit	90 percent will be processed in less than 15 business days of receipt
Ministerial approvals	80 percent will be processed and forwarded to the minister in less than 90 calendar days of receipt
Precedents, rulings, interpretations	80 percent will be processed in less than 180 calendar days of receipt
Nonprecedential confirmations of quality of capital	90 percent will be processed in less than 60 calendar days of receipt
Copies of corporate documents and certificates of confirmation	90 percent will be processed within two business days of receipt

example, some regulatory provisions allow premium rate filings to be “deemed” approved if not acted on within a period of time (such as 30 or 60 days). This time may be extended if the authority requires additional information. Standard response times for various classes of requests must also take into account the time and effort required and the resources available (see box 3). These broad service standards are indications only and should not undermine the authority's prioritization of its resources.

It is recommended that actual expenditures be compared with budgets and other benchmarks and be reported. Publication of the priorities and service standards, with actual results, can help to illustrate existing levels of productivity and indicate areas that could benefit from improvements in responsiveness if additional resources become available.

Hierarchy of laws

Regulation of business in any country needs to fit the prevailing political and economic policies to be effective. The first prerequisite is to have a consistently applied hierarchy of laws. In a typical democratic system, this means laws enacted by the legislature or parliament, with some form of review by the executive branch and interpretation by the judiciary. Also typical is the articulation of regulatory policy and the creation and enabling of a supervisory authority by laws enacted by the legislature.

To implement such laws, the legislature empowers the relevant ministry or supervisory authority to issue regulations, guidelines, interpretive circulars, and other forms of rulings to give market participants a guide to expected behavior. Regulations typically address technical details such as accounting and reporting requirements, the maximum interest rate that may be used when calculating technical provisions, or rules for diversifying assets. While laws state the principles of supervision, regulations include more specific requirements because they can be revised more easily to suit changing conditions. For example, a law may prohibit misrepresentation of the terms and conditions of insurance contracts. A regulation may specify actions that are considered misrepresentation. Many supervisory authorities also issue guidelines. While guidelines may not be strictly enforceable, they can play an important role in communicating supervisory expectations to market participants, for example, regarding appropriate risk management practices. The laws and regulations of other bodies, such as those regulating banking, securities, corporations, or labor, may influence the behavior of insurance market participants as well.

The legal system has to clarify which of the laws, regulations, and other rulings take precedence and ensure they are reasonably consistent in intent and application. It is also very important that, once enacted or promulgated, they are readily available to market participants and the general public.

C. Legal framework and powers

To lessen the potential for disputes with other government agencies, with supervisors in other jurisdictions, or with the supervised entities, the supervisory authority's powers and functions should be clearly specified, preferably within the enabling statute.

In some countries, the laws governing financial institutions and their supervision are so detailed as to leave little room for independent rule making. In others, the laws merely establish a broad framework, leaving much greater scope for supervisory discretion. Countries with a common-law tradition tend to have less precision in their statutes. As Pfennigsdorf (1969, p. 461) has noted,

Under the traditions of the civil law system, statutes are not only the supreme source of law but also the primary source of law. . . . Consistency and clarity of language, the careful grammatical construction of sentences, and systematic organization are at the heart of the drafting process. . . . In marked contrast, American insurance codes reflect the much more pragmatic case-by-case approach of Anglo-American case law. Legislatures, like courts, deal with one problem at a time. . . . The resulting "codes" are therefore, as a rule, not comprehensive and systematic codifications but loose collections of hundreds of individual enactments.

Regardless of a country's particular legal traditions, insurance supervisors need adequate powers and supervisory tools for flexible, preventive, and efficient monitoring and intervention within the broad confines of the country's laws and constitution. Most jurisdictions give the supervisory authority fairly broad discretionary powers, both because it is difficult to anticipate all of the issues that may arise and because the authority's staff are expected to possess special expertise to determine appropriate actions within a broad mandate. Nevertheless, a clear framework for the exercise of this discretion is required.

Clear legal authority

Like other administrative agencies, an insurance supervisory authority (whether public or private) derives its authority from laws enacted by the legislature. These laws empower insurance supervisors to develop detailed regulations and adjudicate disputes. Generally, the legislature also grants to the supervisor the authority to enforce all insurance laws (although sometimes in conjunction with other officials, such as in cases involving the imposition of monetary penalties or imprisonment).

The insurance code is the systematic collection of all insurance laws in a jurisdiction. In one sense, the authority of the supervisor comes from the cumulative provisions that mandate or prohibit behavior in many areas. For example, if the insurance

law prohibits insurers from misrepresenting the terms of their policies, the supervisor must have the legal authority to scrutinize the policies and marketing materials of the insurers operating in that jurisdiction. This scrutiny may include detailed requirements for filing material and both mandatory and prohibitive rules on content. Or it may simply empower the supervisory authority to gain access to company records and apply discretion under a rule requiring full disclosure. In this way, the legislature typically delegates to the supervisor the responsibility for enforcing a large body of laws.

When laws evolve in a piecemeal fashion, as they often do, they may contain contradictions or omit important points. In the United States, the Wisconsin Insurance Law provides exceptional clarity because the previous insurance laws were carefully redrafted into a coherent statute enacted in 1971. Based on explicitly stated purposes, it includes provisions guiding the formation and operation of the Office of the Commissioner of Insurance and details its authority. Various provisions empower the commissioner to take specific action to grant and limit the operating authority of a company or agent, to impose civil penalties, and to seek assistance from the attorney general and other law enforcement authorities if additional actions are needed to support its authority. The law provides for funding the office through fees and assessments. It also delineates specific powers of rule making and enforcement as well as powers to compel reports and provide access to licensee records.⁴

In the United Kingdom, the recently established Financial Services Authority provides another example of clearly articulated objectives and approaches. The main responsibilities are authorization to do business, setting of prudential and conduct-of-business standards, supervision of firms, enforcement of regulatory decisions, response to financial crime, response to consumer complaints, and cooperation with European Union and other foreign supervisors.⁵

As conditions change, laws may need to be revised. For example, the law might require a specific amount of minimum capital for an insurer to obtain a license. After several years of inflation, that amount can become woefully inadequate. Sometimes the legislature has the wisdom to anticipate such changes, in which case the law may establish a minimum capital requirement but allow the supervisor to determine the specific amount. Even so, periodic revisions are necessary to reflect changing circumstances.

Broad and specific powers

Regardless of the level of detail contained in the enabling legislation, the supervisory authority must have sufficient latitude to exercise its functions in a preventive manner. It must safeguard the interests of policyholders and maintain public confidence in the

4. Extracts from this statute illustrate key points discussed below. The entire statute can be accessed at <http://folio.legis.state.wi.us>.

5. A concise brochure explains the FSA (see FSA 2001). Much more information and examples of many of the concepts presented in this module can be found on the FSA website: www.fsa.gov.uk.

financial system. If, despite the safeguards, these interests are endangered already, the supervisor must have tools to intervene immediately (see ICP 14).

In some countries, a general clause in the law gives the supervisor the power to react flexibly, efficiently, and in line with the principle of proportionality. Such a general clause says that the supervisor can take any action that is appropriate and necessary to prevent or remedy any irregularities. An irregularity shall be deemed any conduct of an insurance enterprise that conflicts with the supervisory objectives mentioned in the law.

Such a clause generally applies only in situations for which specific powers are not mentioned in the law. Thus it may apply to a new line of insurance business or a new business practice not contemplated when the laws and regulations were written. It is a kind of supervisory safety net. The objection that such a clause is unacceptably vague can be overcome if the objective is clearly defined. The exercise of the power must be consistent with the principle that those subject to the rules should be given sufficient notice of their requirements before being sanctioned for failure to comply. Moreover, decisions of the supervisor are generally subject to appeal, whether to the minister to whom the supervisory authority reports, to the courts, or to an independent tribunal.

ASSUMPTION OF SPECIAL INSURANCE EXPERTISE

Legislators delegate responsibilities to the supervisory authority because they have neither the time to pass all the rules and regulations necessary to implement legislation nor sufficient expertise in every area of regulation. Moreover, they cannot settle the disputes that arise from legislation, rules, and regulations.

In some countries, the government exercises the power to issue regulations on detailed technical questions, such as whether the maximum interest rate that may be used when calculating technical provisions is too high. It is better to leave technical rules to the supervisory authority. The insurance supervisory authority has greater knowledge of insurance matters, has more experience, and is responsible for achieving the legally fixed supervisory objectives. The presumption that the insurance supervisor has special expertise places the burden on anyone who challenges the supervisory authority's decision to disprove its soundness, within the scope of the discretion given the authority. Because of this assumption, the actions of the supervisory authority can be overturned on appeal only if they are found to be arbitrary, capricious, or an abuse of discretion.

APPEAL AND JUDICIAL REVIEW

The enabling legislation for a supervisory authority usually indicates the right to appeal, whether the appeal is to a court or within the authority. Within the authority, there are usually at least one, and sometimes three or four, tiers of appeal. (There may also be

an intermediate appeal board, which is independent of the supervisory authority, but which can be used to avoid the costs and delays possible in the court system and to provide a more knowledgeable forum for the appeal.) Once a party has exhausted all administrative remedies, it can seek judicial review in a court of law.

On appeal, an aggrieved party may cite errors in the administrative process or application of the law and regulations. Parties often allege that a supervisor's action was arbitrary and capricious or an abuse of discretion. An action is arbitrary or capricious if it is so clearly erroneous that it has no rational basis or if it is willful and unreasonable. Generally, courts give great deference to supervisors' conclusions on questions of fact because they are assumed to have special knowledge and expertise. In cases in which reviewing courts believe that they need more facts to make a judgment, they often remand cases back to the authority for additional hearings.

CLEAR JURISDICTION

In some countries, several bodies with different structures and different duties exercise supervision. For example, the finance ministry has responsibility for the licensing procedure, the autonomous supervisory authority exercises ongoing supervision, and a court authorizes a portfolio transfer. In another example, some jurisdictions give the insurance authority power over health insurance and a health regulatory authority power over health maintenance organizations. These may overlap in certain licensee operations. Similarly, aspects of pension plans may be regulated both by an insurance authority and by a labor secretariat.

Such divisions of responsibility complicate the task of supervision. If one authority has sole responsibility, there are less time wasted in discussions of different opinions, less potential for conflicts of interest, and less need to harmonize divergent policies and approaches. Overlapping responsibilities can leave gaps in supervision and burden supervised entities with redundant requirements.

Many observers believe that independent supervisors (public or private), not a government department (such as a corporate registry) or minister, should be given sole authority to grant and withdraw licenses. Supervisors have ongoing responsibility for monitoring the capital, business plan, and other conditions of the license. What happens if the supervisor concludes that the other authority has made a mistake in licensing the company? Is the supervisor's power circumscribed by someone else's prior decision? Another reason to vest licensing authority with the supervisor is that the threat to revoke a license is a powerful tool for enforcing other rules.

The supervisory authority should have significant input into the issuance of regulations for the insurance market. Otherwise the potential for conflict may undermine the effectiveness of supervision.

Power to discharge responsibilities

The law must provide the supervisory authority with sufficient instruments to be able to fulfill its duties. These powers assure that the supervisory authority receives any information it requires, that it can conduct on-site inspections at the head offices of the supervised entities, and that it can impose sanctions—ranging from admonitions to the withdrawal of a license—if an insurer breaches the legal requirements.

The powers given to the supervisory authority should correspond to the objectives. If it is to monitor the solvency of insurers operating in the market, the authority must have access to information about their assets and liabilities and the ability to confirm adherence to appropriate accounting standards. If the law requires managers and directors of an insurer to be fit and proper, the supervisory authority must have the power to investigate the background of managers and directors and to reject or remove anyone not found fit and proper. These powers must be stated or implied with sufficient clarity to overcome the legal objections likely to be raised.

AUTHORIZATION OF INSURERS AND INTERMEDIARIES

For an insurer to operate in most jurisdictions, or for an intermediary to solicit business in a jurisdiction, each must receive express permission in the form of a license, generally referred to as a certificate of authority for insurers. The licensing process involves submission of required documents such as biographical affidavits of prospective managers and directors, corporate charter and bylaws, financial statements, business plans, and other documents. Unless another unit of the government exercises this responsibility, the supervisory authority needs the legal power to require the submission of necessary information, to review and investigate its substance, and to approve or reject the application.

It is common for insurance entities to be registered or incorporated under normal business laws. This incorporation is then coordinated with the licensing process.

RULE MAKING

The law should give the supervisor the power to issue and enforce rules by administrative means (ICP 3, essential criterion b). Legislation cannot possibly address every situation that might arise, nor can it be updated readily for changing circumstances. Laws articulate general principles and delegate responsibility for the details to the supervisory authority.

Insurance regulations set specific technical requirements for insurers and intermediaries. Once a regulation is final, it usually has the same legal effect as a statute passed by the legislature, although it is subordinate to the statutes in terms of purpose and

scope of authority. According to normal due-process requirements, regulations must be adopted by fair procedures, including advance notice to anyone who must comply with them as well as an opportunity to comment. Refer to ICP 4 on the supervisory process, which requires that the authority adopt a transparent approach to the regulatory process.

The authority can also issue bulletins, circular letters, guidance papers, and other communications to the insurance market, explaining expectations for compliance with statutory and regulatory requirements. These communications state the supervisor's position on a subject without making that position a statement of law.

POWER TO OBTAIN INFORMATION

The soundness of an insurer can only be ascertained through analysis of its financial information. Supervisors must be able to require insurers to submit appropriate financial information in a form and a time that facilitate this analysis (see ICP 12).

Since supervisors may need additional information in certain cases, they should also have the legal power to compel supplementary reports and subpoena power. A subpoena is a legal command to appear at a certain place and time and to testify or produce documents. A legislative grant of subpoena power is necessary because a supervisory authority has no inherent right to issue subpoenas. However, a legislative body can delegate subpoena power to a supervisory authority to assist it in acquiring

Box 4. Example from the Wisconsin Statute

601.42 Reports and replies. (1g) Reports. The commissioner may require any of the following from any person subject to regulation under chs. 600 to 655:

- (a) Statements, reports, answers to questionnaires, and other information, and evidence thereof, in whatever reasonable form the commissioner designates, and at such reasonable intervals as the commissioner chooses, or from time to time.
- (b) Full explanation of the programming of any data storage or communication system in use.
- (c) That information from any books, records, electronic data-processing systems, computers, or any other information storage system be made available to the commissioner at any reasonable time and in any reasonable manner.
- (d) Statements, reports, answers to questionnaires or other information, or reports, audits, or certification from a certified public accountant or an actuary approved by the commissioner, relating to the extent liabilities of a health maintenance organization insurer are or will be liabilities for health care costs for which an enrollee or policyholder of the health maintenance organization is not liable to any person under s. 609.91.

information, if the authority issues the subpoena in connection with an otherwise lawful investigation.

Supervisors also need access to insurers' records and premises (see ICP 13). In most countries, supervisory authorities are empowered to conduct on-site examinations in insurers' offices. These inspections enable authorities to confirm the information submitted, verify compliance with regulations, and obtain additional up-to-date information from the insurer. Such inspections may be carried out periodically or without forewarning, and they may be comprehensive or targeted at specific operations only. To be effective, inspectors from supervisory authorities should have access to any relevant document.

Many insurance companies operate in multiple jurisdictions. Supervisory authorities in the various jurisdictions involved should be able to cooperate and share information needed to supervise such companies (see ICP 5).

TIMELY INTERVENTION

The financial position of an insurer can deteriorate rapidly. To minimize the danger to policyholders, insurance supervisors must have the ability to act quickly (see ICP 14). The worst possible scenario is for the supervisor to attempt to take action, which is then delayed by protracted legal proceedings. The authority for timely intervention must be clear.

The power to issue cease-and-desist orders enables insurance supervisors to bring an immediate end to fraudulent, deceptive, or unauthorized business practices or operations. A cease-and-desist order, for example, might be issued against an unauthorized entity selling insurance.

PENALTIES AND SANCTIONS

Rules that are not followed have little benefit. Supervisory authorities must have the means to monitor and enforce compliance with their rules (see ICP 14). Timely submission of financial reports, for example, can be problematic in some emerging markets. Supervisors in this situation sometimes see little improvement until they impose fines against the entities failing to comply with the requirement. Thus the authority to impose fines should be stated explicitly to withstand a challenge in court.⁶

In addition to fines, other sanctions can include specific directions to the management, removal of responsible personnel (the chief executive officer, the actuary, asset manager, auditor, or other management or directors), freezing of assets, control of as-

6. While it is important for supervisors to have this power, it should not substitute for an open and direct relationship with the management of the insurance company. Sometimes apparent lack of compliance results from misunderstanding or misinterpreting the roles or requirements on both sides. An open letter to the chief executive officer or personal discussions with the board of directors might resolve the situation without recourse to sanctions.

sets, transfer of whole or part of the portfolio, withdrawal of the license, withdrawal of the license for a particular product or line of business, and requirement of plans for restoring the financial position of the insurer.

In general, regulatory systems must assume that most of the supervised entities will readily comply with most of the rules. Supervisory authorities do not have sufficient resources to enforce rules that are widely broken. In practice, many penalties and sanctions are applied to reinforce the idea that voluntary compliance should be the norm.

CONSUMER ASSISTANCE

Supervisors seek and expect the fair treatment of policyholders (see ICP 25). In a number of countries, the legislature, government, or the insurance industry itself has established institutions to resolve consumer complaints. One example is the office of an ombudsman, which has the power to resolve disputes between insurers or intermediaries and customers.

In other countries, the supervisory authority performs a similar function through a consumer complaints division. This division responds to consumer complaints and investigates disputes with insurance companies regarding the settlement of claims or provisions of the insurance contract. Although most disputes are resolved simply by clarifying the facts, the insurance supervisor may have the power to compel the insurer to make a specific settlement. Supervisors are reluctant, however, to take on the role of arbitrator even in those jurisdictions where the power does exist.

Consumer assistance often produces useful information. By monitoring consumer complaints, a supervisory staff gains a better understanding of the operational risks of the regulated insurer, their areas of weaknesses, and potential problems.

RESPONSE TO UNLAWFUL CONSUMER TREATMENT AND FINANCIAL CRIMES

The analysis of consumer complaints activity sometimes reveals patterns of unlawful treatment of consumers, such as failure to provide coverage as promised, failure to pay reasonable amounts of claims, failure to pay claims in a reasonable time, or misrepresentation of the insurance policy terms. This conduct may lead to disciplinary actions, with fines or even revocation of a license.

The possibility that insurance transactions might be used to launder money or finance terrorism necessitates an additional level of vigilance on the part of supervisory authorities. The law should give the authority the power to compel insurers to implement anti-money laundering and anti-terrorism financing measures and to provide the information needed to trace the flow of funds in any suspicious situation. Refer to ICP 28 on anti-money laundering and combating the financing of terrorism (AML/CFT),

which describes the requirements that the supervisory authority should place on insurers and intermediaries.

Perhaps more than any other responsibility, the investigation of financial crimes involves cooperation with law enforcement officials and other units of government, as well as authorities in other countries. The legal framework should contemplate this possibility so that there is no hesitancy in taking action if the need arises.

Power to accept and hold deposits

Some situations may require the supervisory authority to accept and hold deposits. Insurers based elsewhere seeking authorization to carry on business in the country may be required to deposit funds that will be available to settle disputed obligations. In some countries, all insurers (or at least insurers offering life insurance products) must deposit funds with the supervisory authority. Some policyholder protection schemes involve advance funding, which may require insurers to deposit funds with the supervisory authority. To address such situations, the law should explicitly empower the supervisory authority to accept and hold deposits, directly or through another agency with general deposit-holding functions.

RECEIVERSHIP

Insurance supervisors have a special role in handling financially troubled insurers (see ICP 16). Policyholders may be the biggest losers when an insurer fails. Subjecting insurers to the normal corporate bankruptcy laws does not go far enough to protect the ongoing business value that can be critical to protecting the policyholders' best interest. Flexibility in intervention is important for preserving value, and insurance supervisors should have special powers to intervene on policyholders' behalf to preserve the insurer's financial resources to the maximum extent possible. If they have the legal power to do so, they can take over the management of the insurer or direct the appointment of outside experts, attempt to stabilize and rehabilitate the insurer's operations, or conduct an orderly runoff and liquidation.

PARTICIPATION IN OTHER PUBLIC ISSUES

The supervisory authority should be a source of expertise within the government on issues related to insurance. It can have a dynamic influence on the evolution of the insurance industry. Not only are supervisors responsible for monitoring the reliability of insurance businesses, but their expertise can also contribute to the public policy de-

bates. The following are some examples of issues with insurance dimensions that cross over into other policy areas:

- Public and private pensions
- Health care financing
- Public group insurance
- Public risk management and insurance procurement
- Workers' compensation
- Mandatory motor insurance and highway safety
- Emergency relief.

This is not to say that supervisors should be policymakers in these areas, only that their knowledge and experience can be relevant.

POWERS SPECIFICALLY GRANTED OR REASONABLY IMPLIED

In addition to the powers specifically granted in the enabling legislation, other powers may be reasonably implied because they are needed to execute the designated responsibilities. As noted, supervisory authorities are typically given broad authority for implementing and enforcing insurance laws in accordance with the objectives of the laws, including the authority to go beyond explicitly specified actions and apply reasonable discretion as needed to achieve those objectives.

Internal organizational structure

Each regulator should structure its office to carry out its duties most effectively. Various models are conceivable, depending on the specific duties stated in the law and required by the insurance market within the jurisdiction. The organization also depends on the size of the operation, since little specialization is practical in a small office.

A division in charge of general administration (such as personnel, organization, budget, general legal issues, data processing, and media and public relations) is certainly necessary.

A separate division for market conduct might monitor business conduct, advertising, insurance contract provisions, and other matters relating to the fair treatment of policyholders. This division might also include a consumer protection section to handle all complaints or questions from policyholders and to promote consumer education.

Another division might handle the licensing, training, and competency requirements and the monitoring of intermediaries.

Company licensing can be the responsibility of another unit.

The financial analysis of insurance companies can be structured according to the main business lines, one division specializing in life insurance and another in non-life. It would also be possible to classify the insurers by groups, but it may be difficult to find staff with expertise in all lines of business.

On-site examinations could be the responsibility of another division.

In another model, one team of actuaries, economists, auditors, and lawyers could perform licensing and ongoing supervision, financial analysis, and on-site inspections rather than delegate these functions to different organizational units. This structure prevents the loss of information and time and minimizes conflicts between units. Moreover, the responsibility of the supervisor is clearer and more transparent if all operational work regarding an insurance company is concentrated in one team leader than if it is distributed to several different units of the supervisory authority.

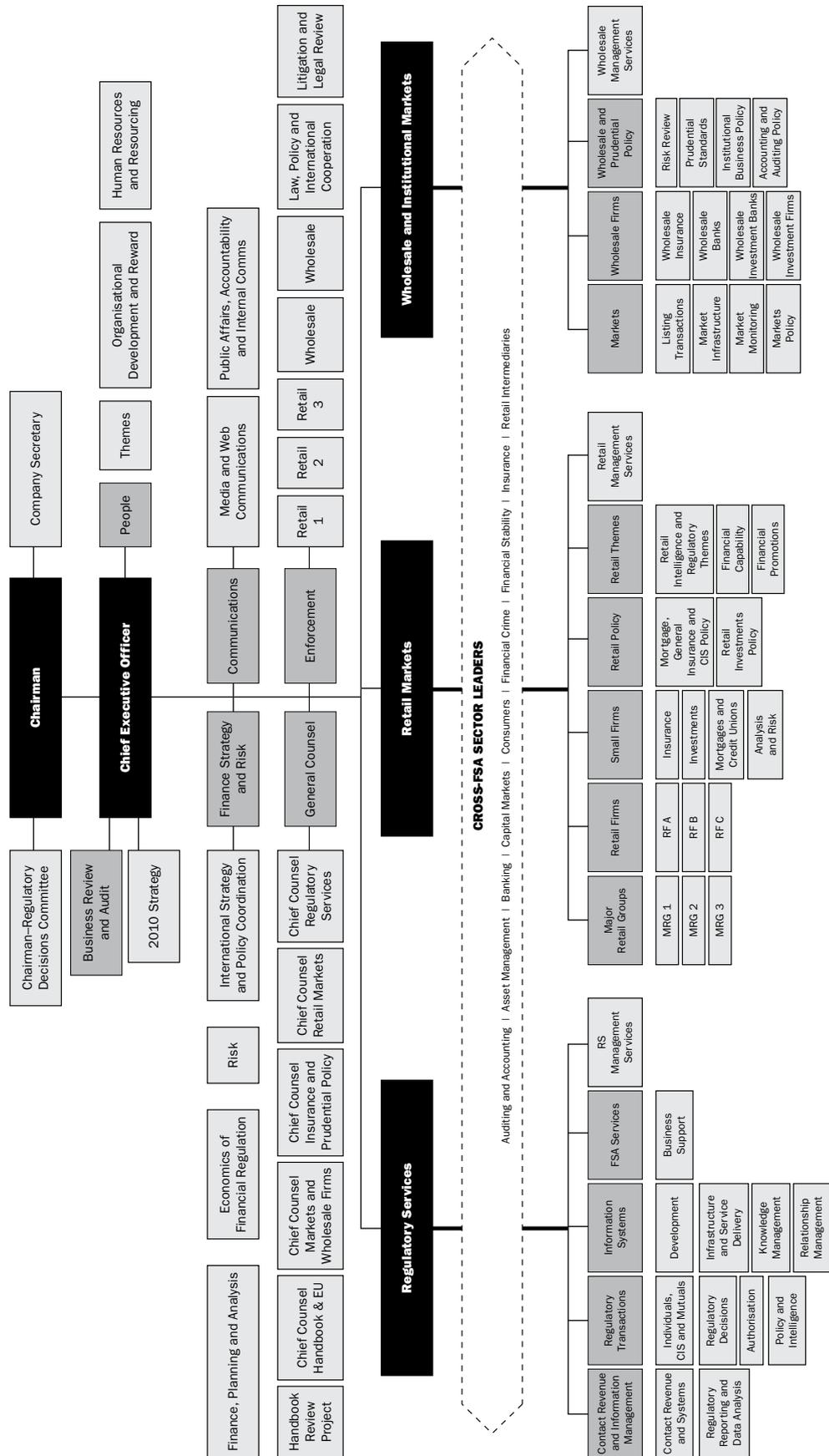
Over the last 20 years, many countries, including Australia, Canada, Denmark, Hungary, Japan, Republic of Korea, Norway, Singapore, Sweden, and the United Kingdom, have moved toward an integrated supervisory structure for the financial sector. In the United Kingdom, for example, the Financial Services Authority has responsibility for all financial institutions (see box 5). “Corporate” functions (such as legal, human resources, media relations, finance, and planning) are centralized. A separate division supervises insurance firms, but consumer protection activities are combined for all financial services. The rapid pace of product innovation and development, coupled with increasingly sophisticated asset-liability management techniques, can present supervisors with products and practices that require highly specialized knowledge. For example, life insurance products sold through banks, insurance agents, stockbrokers, or life insurance brokers challenge supervisors to maintain the same standard of market conduct and to protect clients’ interests regardless of the type of channel.

Supporters of integrated supervision argue that this structure offers efficiencies in staff allocation. The integrated structure should ease the difficulty of supervising financial conglomerates. It is consistent with current efforts to harmonize regulatory rules and practices among the supervisory authorities for banking, securities, and insurance, in recognition of their collective importance in the maintenance of economic stability, nationally and globally.

Exercise

- 1. The finance minister issues a regulation that sets the maximum interest rate that may be used when calculating technical provisions for life insurance. Do you see any problems for the effective supervision of life insurers operating in the country? If so, what are they?**

Box 5. Organizational Chart of the Financial Services Authority in the United Kingdom



D. Independence and accountability

This raises the issue of the supervisor's independence, by law and in practice. The supervisor may be given certain powers, subject only to being overturned by the judiciary for exceeding its powers. The supervised entities can be expected to question the supervisor's authority. In addition, if appointed, the supervisor may be subject to various pressures from the appointer. If elected by the people, there is pressure from the general public. As an accepted government function, insurance supervision ultimately reflects political imperatives. No matter how professional, the staff are never completely autonomous. The more visible insurance issues become, the greater the political pressure for supervisors to conform to prevailing public sentiments.

To guide the market effectively, the supervisory authority must be able to take necessary decisions even if they are unpopular. The structural arrangements can play a major role in promoting the objectivity and independence of the supervisory authority. An international consensus has emerged favoring independent authorities. According to an International Monetary Fund working paper (Quintyn and Taylor 2004, p. 11),

Mounting evidence indicates that independent regulators have increased the efficiency and effectiveness of regulation and helped markets operate more smoothly and efficiently. And the concept of central bank independence has gained near-universal acceptance over the past two decades, as independent central banks have shown that they can successfully pursue monetary stability. Regulatory and supervisory independence in the financial sector complements central bank independence in achieving and preserving the twin goals of monetary and financial stability.

Governance structure

The independence and accountability of the supervisory authority depend on a carefully devised governance structure. The procedures for appointment and dismissal, oversight, and relationships with other government bodies should be clearly established. Clear policies and transparent processes help to protect the supervisor's political independence and assure the presence of the special expertise in insurance that is an essential ingredient supporting the granting of broad discretionary power.

APPOINTMENT AND DISMISSAL PROCEDURES

One aspect of supervisory independence is the security of tenure in office. Clear rules should govern the appointment and dismissal of senior personnel. The law establishing the supervisory authority should define explicitly who nominates and who appoints

the leader and the deputy leader of the supervisory authority. Normally, this would be the body that oversees the insurance regulatory authority, the parliament, the executive (governor, prime minister, finance minister), or a governing council. The involvement of two separate bodies in the appointment process provides a salutary check and balance.

Like the directors and senior management of the supervised entities (see ICP 7), the senior staff of the supervisory authority must be fit and proper. Knowledge of the insurance business, experience in supervision of financial markets, leadership qualifications, and integrity are the essential criteria for the leader and the deputy of the supervisory agency. Many appointees have strong political connections but may lack insurance or regulatory expertise. At minimum, senior staff need to have strong insurance expertise.

The procedures regarding the appointment and dismissal of the leader and the deputy should be defined in the law. If the leader or the deputy is removed, other than at the normal expiration of the term of office, the public should expect the decision to be justified publicly on the basis of incompetence or abuse of discretion, not on the basis of unpopular decisions.

For the sake of continuity, long-term contracts (perhaps of five-year duration) are preferable to short-term contracts. A rule or practice requiring the head of the supervisory authority to resign when the government changes also disrupts continuity.

The head of the insurance supervisory authority should appoint the other staff. If the government can impose senior staff on the authority, there is the potential for undue influence, and it is more difficult to hold the head accountable for achieving supervisory objectives. The supervised companies, the public, and the insurance supervisory authority itself have a strong interest in an appointment process that guarantees objectivity, continuity, integrity, and competence of the authority and its staff. Political influence tends to undermine public confidence.

OVERSIGHT

Oversight of insurance supervision should be given to a body that can protect the independence of the supervisory authority, while holding it accountable within its legislatively defined objectives. In some countries, parliament exercises this oversight. Another solution could be to establish an administrative council or board of directors for the supervisory authority. In either case, the oversight body should have multiple members, representing diverse backgrounds, interests, and expertise in insurance. While it is desirable to include knowledgeable people, perhaps even representatives of the insurance companies and intermediaries, as well as representatives of consumer protection organizations or other independent public members, the oversight body must be perceived as neutral and reliable. If the oversight body has any role in supervisory decisions, such as approving applications for a license, it should not include currently active industry

representatives. To do so would compromise the real and apparent independence of the supervisory authority.

INSTITUTIONAL RELATIONSHIPS

The legal framework should clearly define the authority's relationships with the executive, legislative, and judicial branches. For example, if the supervisor must inform, consult, or seek the approval of the finance ministry on certain issues, those issues should be clearly delineated. The manner in which the supervisor has access to the government should also be clear. Similarly parliamentary oversight procedures must be carefully defined. And the exercise of supervisory powers should be subject to judicial review.

Prudent supervisors usually do their best to be informed about the intentions, wishes, and opinions of the political leadership and to anticipate their reactions to new policy proposals. This kind of dialog serves to align supervisory initiatives with political realities. At the same time, it should not compromise the supervisor's political independence.

POLITICAL INDEPENDENCE

To perform its duties properly, the supervisory authority should have autonomy of action. Accordingly, ICP 3, essential criterion g, stipulates as follows:

The supervisory authority and its staff are free from undue political, governmental, and industry interference in the performance of supervisory responsibilities.

The requirement for the supervisor's independence should be laid down explicitly in the law. Such an article could be formulated as follows: "In exercising the power conferred on it by this act, the supervisory authority shall be independent and not subject to directions, guidelines, or instructions from the government." Such language helps to shield the supervisor from politically biased interference.

Democratic countries value the idea that the government represents the people. The independence of the supervisory authority can seem alien to the democratic ideal. Often governments argue that they have to take "political responsibility" for the state of the market. In many countries, the government gives the supervisor general guidance or directions concerning insurance in relation to development of the financial market. For example, the government might seek to encourage or to limit foreign investment in the industry.

A government, however, can have totally different objectives than the insurance supervisor. Occasionally, the government might give directions, disregarding the responsibility, knowledge, and experience of the supervisor. The following are some examples of such interference:

- Instructions to freeze premiums in motor third-party liability insurance until after elections
- Pressure for insurers to underwrite risks that are not insurable, such as natural catastrophes, or are insurable only under special arrangements, such as terrorism or nuclear risks
- Pressure to approve a license for an unqualified company
- Pressure to block the removal of a manager who is not fit and proper but is a good friend of a powerful politician
- Instructions to allow an insurance company to hold risky assets normally not permitted
- Recommendation of a particular wording in the insurance legislation that benefits a special interest.

Undue influence can also come from the industry. In a sound market, the industry usually recognizes that effective supervision is in its interest as well as in that of the policyholders. They know that supervisory measures are necessary to prevent or to rectify failures or abuses that can undermine the image of the insurance industry. However, some industry participants may nevertheless seek to prevent the adoption or application of appropriate regulatory or supervisory measures that they consider to be contrary to their own interests.

In an idealized view of economic regulation, the regulator acts only in ways that benefit the public. Regulation imposes order in the marketplace and prevents potential evils and abuses, preserving a strong, efficient, open, competitive, and transparent market. Thus the supervisor represents the public at large and serves its best interests. A seminal article by the Nobel-prize economist George Stigler, however, casts doubt that broadly based public interest necessarily prevails in influencing the direction of regulation (Stigler 1971). Supervisors may feel much more intense political pressure from special interest groups most affected by their decisions than from the public at large. As supervisory authorities evolve, the staff's commitment to the authority's original objectives may wane, and some relevant interest groups may lose their initial enthusiasm. Furthermore, the authority often must depend on the industry for the information, expertise, and analysis that support its eventual decisions. These circumstances can lead to the "capture" of the regulator by the regulated. Supervision then might tend to serve the interests of the industry more than that of the general public, which is less adequately represented.⁷

7. The many interests theory holds that several special interest groups contend for influence over regulation, and the regulator balances these contending interests and responds in ways that achieve the greatest political benefits (Posner 1974). According to public choice theory, while regulators respond to the political pressures of contending special interests, they

The technical complexity of insurance makes insurance supervision especially susceptible to capture. Supervisors must consult frequently with the supervised firms or professional associations to obtain information and to ascertain the ramifications of possible supervisory actions. Emerging-market supervisors are even more susceptible because the supervision of growing markets typically needs frequent adjustments, which accentuates the voices of the industry. The risks of capture are greatest during times of substantial change in supervisory approach, such as when the supervisor eliminates prior approval of products or broadens the restrictions on investment.

The revolving door through which former insurance supervisory personnel sometimes find subsequent employment in the industry can be a sign of capture, but not necessarily, since individuals with such experience offer obvious value to insurers. Other signs of capture are frequent use of discretionary powers, failure to enforce the rules, failure to take timely preventive action, and the giving of inappropriate advice to the government. A capture problem may also exist when outside observers find fault with the quality of supervision, but the authority itself is satisfied. If the issues are complex, the authority may be right, but for the sake of consumer confidence, it still needs to educate its critics.

The risk of regulatory capture exists for all supervisors. A normal reaction might be to avoid public contact with insurers, but such impulses are counterproductive. Consultation is an important part of supervision. The best defense against regulatory capture is for the supervisor to recognize the risk, to maintain vigilance in resisting it, and to display complete transparency in dealing with the industry.

Strong safeguards against capture include the following:

- Clear description of the supervisory mandate so that stakeholders can understand the deliverables and objectives
- Clear messages to all supervisory personnel emphasizing the need to form independent judgments, taking account of the interests of consumers and policyholders as well as the industry
- Reminders to the industry of the supervisor's role and the necessity for independence
- Public notice of supervisory actions to the maximum extent possible, consistent with confidentiality of proprietary information of companies
- A rules-based system of sanctions and interventions that lessens the scope for abuse of supervisory discretion
- Graduated responses to signs of financial distress, rather than all-or-nothing situations
- Restrictions on employment in the industry for a period of time after leaving the supervisory authority
- Internal and external assessments of supervisory performance.

advance their own agendas in the process. Regulators seek the position because it gives them discretionary power. Some are zealots determined to remedy social evils. Others are empire builders or placeholders. In any case, this view holds that the regulators themselves determine the goals of regulation. Their initiatives or lack thereof also influence the political process. Thus regulatory activity by any one agency or department follows a cyclical trend, from zealous to lethargic enforcement and back (Mackay and Reid 1979; Reid 1982).

CONFLICTS OF INTEREST

Another safeguard against undue influence is an explicit conflict-of-interest policy. If not already contained in the law, the duty of all staff members to avoid conflicts of interest should be spelled out in a policy statement. The strict prohibition of any conflict of interest should be absolutely clear, and the policy should place the burden of reporting a questionable situation on the individual staff member.

Although more difficult to define, the prohibition should extend to the appearance of conflicts of interest. Even where no actual conflict exists, actions that may give that appearance can undermine public confidence.

The use of information received in a supervisory capacity for personal gain cannot be tolerated. Dealing in shares or investments of supervised insurance companies, for example, should be grounds for dismissal. This rule can present practical problems. For example, if most of the companies trading on the stock exchange are financial institutions, supervisors may be significantly limited in their personal investment options. Even in developed markets, gray areas, such as sector-specific mutual funds, can blur a seemingly distinct line between investments that are permitted and those that are not. Regardless of these complications, supervisors must scrupulously safeguard their integrity or lose effectiveness.

The supervisory authority should also issue a policy statement to all staff regarding gifts and hospitality. Gifts of material value should not be accepted, and hospitality should generally be declined. Permissible exceptions, such as business meals or invitations to a jubilee of an insurance company, a seminar, an annual meeting of the association of insurance companies, or similar insurance-related events, should be spelled out in the policy statement.

Third persons hired by the supervisory authority should be subject to the same requirements as the staff of the authority.

FINANCIAL INDEPENDENCE

Another possible impediment to supervisory independence can be limitations on the allocation of resources. Therefore, essential criterion i stipulates:

The supervisory authority has discretion to allocate its resources in accordance with its mandate and objectives and the risks it perceives.

Overly rigid budget categories can limit the supervisor's discretion. For example, the authority might rely on auditing firms to perform inspections, and the budget might specify a certain level of expenditures per month rather than per year. If the monthly

budget is exhausted, this requirement could obstruct the supervisor's ability to conduct inspections in a timely manner.

Sharing resources with other government agencies might also undermine the supervisor's independence. Computer facilities or specialized expert personnel might be theoretically available to the authority, but be available in practice only if not needed more urgently elsewhere. Priorities then become subject to negotiation rather than the supervisor's discretion.

Any situation in which the resources associated with the authority's mandate can be withheld or redirected by someone else compromises the supervisor's independence.

Supervisory process

An independent supervisory authority works only if it is accountable. The greater the degree of independence, the more important accountability becomes.

Independence and accountability must exist not only in word, but also in deed. These values must be demonstrated continually if the supervisory authority is to gain the respect and credibility needed to function effectively. Clear, transparent, and consistent supervisory procedures establish the supervisor's credibility. When both the public and the industry can scrutinize supervisory decisions, they gain confidence in the process and are more willing to accept the outcome.

Whenever changes in insurance legislation are contemplated, there should be consultation, as ICP 3, essential criterion k, states. A good consultation process includes the following:

- Release of a draft paper presenting the proposed change and reasons for it
- A reasonable period of time for comments to be submitted
- Compilation and consideration of those comments
- A final paper explaining why specific comments were or were not accepted.

The supervisory authority should publish its rules, principles, procedures, and major decisions, as well as relevant statistics, and update them regularly (see box 6 for an example). In its annual report, the supervisory authority can summarize its policy and objectives, the financial situation of the supervised companies, problems in the market, key risks, and specific vulnerabilities. The supervisor can explain the measures taken or contemplated to address these vulnerabilities. The report should describe the most important decisions, the development of the international cooperation and standard-setting work, the human resources of the authority and expenditures in the past year, and the prognosis for the coming year. In addition, the supervisory authority can inform the public through press conferences and press releases. A website can also be an effective way to disseminate this information. Public discussions or seminars provide further opportunities for representatives of the authority to explain supervisory activities.

Box 6. Example from the Wisconsin Statute

601.46 Commissioner's records and reports.

- (1) *Record maintenance.* The commissioner shall maintain the records required by law and those necessary to provide for the continued effective operation of the office, to constitute an adequate and proper recording of its activities, and to protect the rights of the people of this state.
- (2) *Record of proceedings and activities.* The commissioner shall maintain a permanent record of proceedings and important activities, including a concise statement of the condition of each insurer visited or examined and including a record of all certificates of authority and licenses issued.
- (3) *Annual reports.* Prior to September 1 of each year, the commissioner shall submit a report to the governor and to ... the legislature ... which shall include, for the preceding calendar year:
 - (a) [An organizational chart]
 - (b) A general review of the insurance business in this state, including a report on emerging regulatory problems, developments, and trends
 - (c) A summary of the complaints made to or processed by the office about insurers, agents, and others connected with insurance and information about their disposition
 - (d) A summary of rules promulgated and circular letters distributed
 - (e) A list of all insurers authorized to do business in this state during the year, with appropriate and useful information concerning them, including a list of insurers organized, admitted, merged, or withdrawn
 - (f) A list of all revocations of licenses or certificates of authority and the reasons therefore
 - (g) The changes made in [the insurance law],
 - (h) A summary of receipts and expenses, including [examination costs]
 - (i) The kind and amount of insurance carried in all state insurance funds ... and
 - (j) Such other information on the general conduct and condition of insurers doing business in this state as the commissioner or the governor deems necessary or as is prescribed by law.
- (4) *Public inspection.* All records and reports shall be open to public inspection unless specifically otherwise provided by statute or by rule.
- (5) *Copies of records.* The commissioner shall provide to any person on request certified or uncertified copies of any record in the department that is open to public inspection.
- (6) *Audits.* The commissioner shall reimburse the legislative audit bureau for the cost of audits required ...
- (7) *Free distribution.* The commissioner may furnish free copies of the publications prepared under subs. (1) and (2) to public officers and libraries in this state and elsewhere.

Because the process followed by the supervisory authority has a critical impact on its effectiveness, it is the subject of a separate core principle. ICP 4 stipulates:

The supervisory authority conducts its functions in a transparent and accountable manner.

Accordingly, the ICP 4 module addresses the specifics of transparency, accountability, impact assessments, consultation, notice, and the like. The point to emphasize here is that these characteristics of the supervisory process reinforce the independence and accountability of the supervisory authority when they are practiced consistently but undermine it when they are breached.

INTERNAL AND EXTERNAL ASSESSMENTS

Supervisory authorities should monitor their performance and compare it with the established supervisory objectives. Such reviews should be routine, since they also relate to budgeting and personnel management. Internal auditors can also assess the authority's performance against its objectives.

The insurance core principles provide another benchmark against which to measure the performance of a supervisory authority. Insurance supervisors should periodically carry out a self-assessment to determine the extent to which each of the principles is being observed in their jurisdiction. More important than the results of the self-assessment is the action plan developed to introduce new regulations or practices that rectify the gaps identified in the self-assessment exercise.

External assessments also help in monitoring the authority's performance. For example, the Financial Sector Assessment Program (FSAP) is a joint International Monetary Fund (IMF) and World Bank effort to promote the soundness of financial systems. Assessments seek to identify the strengths and vulnerabilities of a country's financial system, to determine how key sources of risk are being managed, to ascertain the sector's developmental and technical assistance needs, and to help prioritize policy responses. While participation in the program is voluntary, there are strong incentives for countries to observe international standards. Observance of standards can determine eligibility for IMF loans, for example. But more important than such official incentives are the market incentives. Capital naturally flows to countries where investors perceive less risk, and observance of international standards signals a favorable investment climate. Some countries have chosen to make their FSAP report public, and these appear on the IMF website.

Exercise

- 2. The finance minister oversees the supervisory authority. Due to the volatile capital market, the supervisory authority issues a circular letter warning insurance companies to exercise caution in equity investments. The finance minister directs the supervisory authority to rescind this warning because it might prompt the companies to sell shares, accelerating the collapse of the capital market. What can the supervisor do in this situation? Is it possible to supervise the companies properly? What might be the consequence for the minister?**

E. Financing

Regardless of the legal authority, the resources available to conduct supervisory activities limit the power of an insurance supervisor. Supervisory authorities must have adequate funding and staffing to monitor insurer solvency and to respond in a timely and responsible manner to consumer concerns, insurer requests, and other demands. Moreover, the resources available to a supervisory office should be commensurate with the size of the industry it is monitoring. Emerging markets must plan for the growth of the supervisory authority.

In most countries of the world, a major challenge for the supervisory authority is to secure sufficient financial resources to execute its responsibilities. To safeguard its independence and effectiveness, the supervisory authority needs a reliable and stable source of funding. Only then can it attract and retain qualified staff, hire outside experts when necessary, acquire and maintain suitable office space and equipment, employ information technology to collect and analyze insurance market data, and pay other necessary expenses.

Methods of financing

Possible sources for funding include general government revenues, levies on supervised entities according to premiums or assets, multilateral and bilateral aid, and, in some cases, the central bank budget.

GENERAL FUNDS

Many insurance supervisors are funded through the general state budget, as an essential part of public administration. Like other departments of the government, the supervisory authority presents its budget requests to the responsible minister or to the legislature, which then reviews the needs and appropriates the taxpayer funds it deems warranted.

General revenue funding frees the supervisory authority from dependence on the industry. However, budgetary problems often force governments to economize. Seldom do legislators weigh the funding of insurance supervision against the resulting revenues and other benefits to the state or the public. They more likely view the authority's budget as a target for cuts with few political consequences, expecting that economies can be achieved with little or no meaningful reduction in supervisory function.

It can be difficult, if not impossible, for the government to differentiate between very important and less important duties that the state has to perform. Therefore, it may implement a uniform salary scale for all civil servants. The quality of the supervisory staff might suffer as a result because the authority cannot hire and maintain experi-

enced actuaries, lawyers, economists, or auditors within the constraints of a uniform salary scale.

General revenue funding can also cause conflicts in regard to the independence of the supervisory authority. For example, a minister could reduce the budget, or threaten to do so, if the supervisory authority does not comply with political objectives.

INDUSTRY LEVIES AND PREMIUM TAXES

Some countries have devised alternate financing mechanisms based on the principle that the cost of a service should be borne by the final consumer. Thus insurance companies pay the expenses of their supervision through industry levies or premium taxes, and the cost of supervision is incorporated into the cost of insurance. Because the main goal of insurance supervision is to protect the consumer, a levy on premiums is an appropriate way to fund supervisory bodies. This method preserves the independence of the authority and provides resources proportional to the size of the industry. An excessive levy, however, might hamper the growth of the insurance market.

When funding comes from the insurance industry, care should be exercised to preclude any perception that the supervisory authority is indebted to the industry. In small or highly concentrated markets, a few companies with large market shares may contribute large portions of the budget, perhaps giving them undue influence in the budgetary process. As a safeguard, the law may stipulate that the parliament, the government, or the supervisory council of the authority must approve the budget. However, the government's power to approve the supervisory budget should be subject to constraints; otherwise, it too threatens the authority's independence. In any case, the financing procedure must be transparent; the budget and the audited financial statements should be published on a regular basis.

In some jurisdictions industry assessments or direct premium taxes may be levied, but the supervisory authority is funded as part of the government budget. Often, the amount of premium tax is not considered in determining the authority's budget. Thus the authority may face pressures for budget cuts despite growth in the revenue raised by the assessment or premium tax. There should be some means of rationalizing the assessment and budget.

FEES AND OTHER REVENUES

In order to reduce the cost to consumers, mixed systems of financing combining state budget resources and levies on premiums are also put in place. The rationale for this is that the general public, as a third party to insurance contracts, also benefits from supervision of the sector. Additional sources of funding could include charges for inspections, fees for services (information and database for industry and consumers), fines

for violations, use of the proceeds of rehabilitations, and liquidations for receivership support. Subcontracting to external entities (auditing and actuarial consultancy firms) might help to optimize the use of available resources.

In some jurisdictions, fees paid by the examined firms fund on-site inspections. This practice relates these costs more specifically to the companies that require the most scrutiny. The cost of third-party support for this process (such as auditors or actuaries) is billed directly or indirectly to the inspected firm.

Reliance on fees, however, complicates budgeting, since no one can predict in advance the services that will be requested. For example, if the authority relies on the fees collected with new license applications, it will not have sufficient revenue for ongoing supervision in a year when no new licenses are sought. An additional risk is that in a financial crisis, the industry might have difficulty paying fees at the moment when resources are needed most.

SPECIAL FUNDS

Some jurisdictions use a combination of funding methods. The government budget provides for the supervisory authority, but it incorporates revenues collected from insurance-related activities. In some cases, these revenues are explicitly designated for funding supervision, with general funds covering the remaining needs. This solution makes budget planning easier and more reliable.

In the United States, the National Association of Insurance Commissioners drafted a Model Insurance Department Funding Law as an example of this arrangement. It establishes a state treasury trust fund designated as the Insurance Regulatory Trust Fund. All payments from insurers and intermediaries for filings, licenses, examinations, and investments go into that fund to defray the expenses of supervision. This fund insulates resources from the political whims of the legislature and is somewhat proportional to the size of the insurance industry to be supervised. Although only a few states have adopted the Model State Insurance Department Funding Bill, it is included in appendix II as an example of such an arrangement.

Even when implemented with the best of intentions, designated fund arrangements tend to erode over time. It is difficult for the legislature to resist the temptation to use the special fund to close gaps elsewhere in the general budget. Nor does the special fund eliminate political influence. Even when the government pays only part of the supervisory expenses, it may want to influence the policy of the supervisory authority.

Budgetary process

A successful and efficient supervisory body requires good planning and proper allocation of resources. Accountability and cost consciousness among staff are also necessary.

Whatever the source of funding, supervisory authorities should be accountable for the resources made available and be obliged to report publicly and regularly on their performance.

A budget is an orderly and coordinated plan of financial planning and management. It is a major tool for planning, motivating, and controlling operations. The budgetary process forces the supervisory authority to determine its goals and objectives and to develop a coordinated plan for achieving these ends.

The authority should be obliged to produce a detailed and well-founded draft of an annual budget with a realistic assessment of the spending needs for the next year. If funding must come from the government budget, the supervisory budget should be proposed and justified by the authority itself, following objective criteria related to developments in the market.

This budget should forecast expenditures for all necessary activities and actions. It should also include contingency funds for unforeseen but possible and necessary actions, such as additional on-site inspections in a crisis situation or the investigation of a financial crime.

Since the supervisory authority is a service organization, its costs depend largely on the number of employees required to perform its functions. Such costs include salaries, pensions, training, and travel. For each task the authority must perform during the budget period, the number of full- and part-time employees required can be estimated based on experience and records from previous periods. The total of these estimates indicates the workforce required, and the employee-related costs can be projected accordingly. Other costs relate to overhead expenses including facilities, consumables, telecommunications, and professional support such as auditors. Most of these overhead costs can be itemized in the budget.

The annual operating costs should also include depreciation of capital expenditures. A newly established authority, in particular, may incur considerable start-up expenses for buildings, equipment, and systems over the initial years. In that case, a separate capital budget may be required. If the authority uses accrual accounting, the capital budget should be linked to the annual operating budget through the depreciation charge, which spreads the capital expenditures over a period reflecting the useful life of the start-up infrastructure. Even new equipment and systems will have to be replaced sometime.

When the draft budget is completed, it may need to be reviewed and approved by an oversight body, whether the parliament or the governing council of the supervisory authority. Once approved, the supervisor should be able to use the budgetary funds as flexibly and as quickly as possible. Supervisors should not be subjected to political pressure through the budget. Although public sector employment laws and union rules can constrain staffing, supervisors otherwise should have the freedom to staff the authority as they see fit and to respond quickly to emerging needs.

ACCOUNTING AND ADMINISTRATION

The second phase of the budgetary control process involves monitoring operations so that operating plans and targets can be attained. Budgetary control relies primarily on analyses of differences (1) between actual and budgeted costs and revenues and (2) between actual and standard costs. Aspects of the control process involve (1) establishing lines of responsibility for performance, (2) communicating plans to those assigned responsibility for performance, (3) evaluating variances between actual results and budgeted estimates, and (4) taking appropriate action.

The supervisory authority should establish an internal auditing system to insure that the authority meets its objectives and complies with the legislation and regulations. Procedures must be in place to ensure the integrity of the supervisory activities and avoid abuse of the discretionary powers given to the supervisor. These internal rules should be disclosed publicly.

The supervisory authority is accountable for its expenditure of funds in several ways. First, it is accountable to the oversight body—parliament or council—that approved the budget. It is also accountable to the industry for executing its responsibilities in an efficient and proper manner. Finally, as a body established in the public interest, the authority is accountable to the public at large.

For these reasons, the authority should generally publish an annual report detailing its budget and its expenditures, although such information may be included in a broader report, such as when the supervisory authority is a department within a government ministry. Its financial statements should be audited and information made available to the public on a regular basis.

Exercise

- 3. The insurance supervisor supervises 11 insurance companies. Five of them are financially troubled and could be liquidated soon. The country's insurance law provides that the supervisory authority is financed by fees for licenses. What problem will the supervisor soon have? What solution might be found?**

F. Capacity

The supervisory authority needs sufficient well-qualified staff, including experienced actuaries, auditors, reinsurance experts, economists, lawyers, and information technology specialists. They must have appropriate levels of skills and experience to meet the demands of supervision. Building and maintaining a good staff are typically two of the greatest challenges facing insurance supervisors.

Concept of professionalism

From medieval times, the unique expertise of doctors, lawyers, and clerics has given them special status as professionals. In more modern times, experts in many other fields have acquired similar status as members of a self-governing profession. These professions involve a high degree of expertise based on an established body of knowledge, a commitment to the public good, rigorous qualification procedures, ethical principles expressed in formal codes of conduct, and disciplinary procedures for errant members. A formal professional body defines the underlying body of knowledge, establishes standards for the practice of the profession, develops procedures for admitting new members, facilitates the exchange of professional information, and presents the view of the profession in an influential manner.

Professionalism connotes not only technical competence in a specialized field but also a high degree of integrity. The public relies on professionals to perform their duties in an expert and conscientious manner. Thus the presence of professionals in the market enhances public confidence.

Professional staff

The supervisory authority should vigorously uphold the concept of professionalism for its staff. It should acknowledge and reinforce the standards set by the relevant professional bodies for accountants, actuaries, and lawyers. It should encourage staff members working in the relevant fields to meet the qualification requirements of these professions, if they have not already.

Appropriate legal protection helps to protect the professional integrity of the supervisory authority's staff. As public officials they should have legal immunity when properly performing administrative and ministerial acts within the scope of their authority. The laws of some countries allow supervisors to be sued personally for their work, but those laws are not consistent with ICP 3. The law should make clear, as in the example presented in box 7, that the government will defend supervisory authority personnel acting in accordance with their mandate. This defense could include appointing public legal counsel and bearing the costs of defense.

Box 7. Example of Legal Protection from the Wisconsin Statute

165.25(6) Attorney for State

- (a) At the request of the head of any department of state government, the attorney general may appear for and defend any state department, or any state officer, employee, or agent of the department in any civil action or other matter brought before a court or an administrative agency which is brought against the state department, or officer, employee, or agent for or on account of any act growing out of or committed in the lawful course of an officer's, employee's, or agent's duties. Witness fees or other expenses determined by the attorney general to be reasonable and necessary to the defense in the action or proceeding shall be paid [by the state]. The attorney general may compromise and settle the action as the attorney general determines to be in the best interest of the state.

Part of the challenge comes from the need for specialized professional expertise. A degree of specialized training and skill is needed to judge the quality of professional services received, and evaluation resides with members of the profession. Professional accreditation procedures involving educational qualifications and proficiency testing assume great importance in admitting new members to the profession. As a result, qualified professionals may be scarce, particularly in developing countries.

Human resource development

Human resource planning involves forecasting the skills needed by the organization and recruiting, selecting, training, appraising, promoting, and rewarding its people accordingly. Making each of these aspects consistent with the others improves the overall results. A consistent and thoughtful approach enables the authority to develop qualified staff and promote from within, to respond to employee ambitions for advancement, to improve productivity, and to reduce turnover.

FORECASTING THE NEED FOR SKILLS

To forecast the need for skills, the authority must first analyze the jobs it must perform. For each job within the authority, the content, requirements, and context of the job should be explicitly defined. *Job content* means a description of the specific duties and tasks involved. *Job requirements* are the necessary qualifications for the job. *Job context* includes the purpose, reporting relationships, level of responsibility, working conditions, and similar factors. *Job descriptions* address the content, requirements, and con-

text of each job and provide the basis for recruitment, training, performance appraisals, compensation, and budgeting.

Job requirements include the knowledge, skills, and abilities needed to perform the job. For insurance supervision, two broad areas of competencies are required: technical and generic. Technical competencies include specific knowledge of insurance principles, accounting methods, actuarial techniques, economics and finance, business law, and information systems. Generic competencies include a range of “soft skills” that are important when working with insurance companies and industry associations. In addition to technical knowledge and experience, insurance supervisors must have good sense, instinct, and leadership capability. They must be able to cooperate not only with colleagues in their country but also with foreign supervisors. Foreign language ability is also useful. Integrity and honesty are essential for all posts within a supervisory body.

Forecasting human resource needs involves not only the specific skills but also the number of staff needed for each area of responsibility. Although an imprecise art, it helps to focus attention on the most pressing needs. Useful questions to ask at this stage include:

- Are we overstaffed or understaffed?
- Could we function efficiently with fewer people? If not, why not?
- In what areas are we most likely to be shorthanded?
- Can we make better use of the talents of existing employees?
- What staff will continue to be available in future periods, after retirements and other departures?
- What needs will arise from anticipated changes (such as opening the market, introducing reinsurance regulation, adopting risk-based supervision)?

After projecting the future supply and demand for human resources, the net balance indicates the appropriate actions to take in terms of recruiting and developing staff to be sure that the right kinds of people will be at the right places at the right times to meet the authority’s responsibilities.

Clear job criteria are needed at the hiring stage. The candidate’s qualifications, especially technical knowledge of insurance, should be carefully considered, matching qualifications and experience to job requirements. For example, the role of an inspector calls for the ability to work independently and may require a strong character. In contrast, a position at headquarters may primarily require the ability to work as part of a team.

TRAINING AND DEVELOPMENT

Educated and experienced insurance supervisors, however, are rarely available in the labor market. Usually the supervisory authority has to train staff itself, at least with re-

spect to the supervisory process and techniques and, for those without industry experience, with respect to insurance-related technical skills. Those without significant prior experience are likely to need more training on “soft” skills. Thus the best composition of staff may be a mixture of experienced supervisors, individuals with significant industry experience but new to supervision, and intelligent young people, who will be trained by the experienced persons. Good results can be achieved if care is given to effective organization of training activities.

In fact, there are advantages to supervisory authorities that assume responsibility for training. If the leader of the authority is directly involved, the staff responds with greater interest. They understand better the value of improving their knowledge and skills. Moreover, curiosity is an essential attribute of supervisors. By creating the culture of a “learning organization,” the authority positions itself to address changing market conditions. Furthermore, if the authority can share its experience, it can be a role model for the country’s insurers, who also need to upgrade their staff competencies to cope with the demands of the global environment.

Thus all training activities have value, but some have more than others. The authority should plan training activities that match its need for human resources. Thus a progression of activities from basic to advanced levels will be needed. Given limited resources, the costs and benefits of various options must also be considered. Possible training options include on-the-job training, in-house training, regional seminars, formal courses, and special postings to other supervisory organizations. Continuing education should underpin all training activities.

On-the-job training. Far too often “on-the-job training” is a euphemism for no training. Properly structured and administered, however, it can play an important role in career development. Assisting on a team with more experienced staff members exposes employees to practical considerations and nuances not usually included in formal training. Better results are likely when more senior staff are assigned specific responsibility for mentoring newer personnel. Rotation of assignments gives new recruits a broader perspective of supervision and how its various aspects relate. This experience makes them better team players since they know who needs what information and why.

On-site inspections, in particular, provide indispensable training for budding supervisors. They learn in practice how insurance works, what risks the insurers take, how they manage these risks, how they calculate the technical provisions, how they choose the reinsurance programs, and so on. They also see first hand the role of intermediaries, actuaries, and each of the various departments within the insurer. The extent and sophistication of underwriting guidelines, internal controls, enterprise risk management systems, and corporate governance procedures can vary widely from insurer to insurer. The information gleaned from each inspection provides a benchmark for comparing other insurers.

Exchange of staff with private firms could also improve the educational level of both supervisors and the staff of insurance companies. Experienced staff of compa-

nies could help the supervisory authority, and more knowledge of supervisory concerns could benefit the companies as well. Concern about sharing trade secrets often makes such exchanges difficult to implement in practice, but exchanges with actuarial consulting firms and audit firms might be easier to arrange.

Special postings. Another possible avenue for practical experience could be to post staff in the supervisory office of another country. Well-established offices in several advanced countries occasionally welcome peers seeking such experience. However, the opportunities for this type of training are limited, since they require considerable time and commitment from the host. They also involve significant costs, not only travel and subsistence, but also time away from the office. If the environment and market conditions of the host country differ drastically from those prevailing in the home country, the knowledge gained may not be of immediate value.

In-house training. Training conducted in-house gives the authority more control over the content and degree of participation. In-house training is particularly effective for conveying content specific to the authority, such as new procedures or initiatives, or for addressing issues or current concerns of the authority. Even if the authority must bring in external resources to present the training, in-house sessions demonstrate the importance the authority assigns to the subject. That message is even stronger when internal resources are used, and having internal people prepare to act as presenters reinforces their knowledge of the material.

Regional seminars. To achieve economies of scale, cooperation in training on a regional basis should be considered. Regional seminars can impart theoretical knowledge effectively, but they should not consist of one-time events. While the first seminar might provide a general overview of supervision, it should be followed by seminars addressing specific areas, such as the calculation of technical provisions or the supervision of a particular line of business, such as motor insurance. An added benefit of regional seminars is the opportunity to network and build relationships among regional supervisors and thus promote regulatory cooperation.

Formal courses. Since formal courses offer defined content and usually include examinations, they provide a clearer measure of the learning achieved. For some employees, university courses may be appropriate to fill gaps and to prepare for specific responsibilities. Actuarial training programs may be available in the region or can be established with the assistance of the International Actuarial Association. Many countries have insurance institutes offering courses for the industry, and those institutes cooperate globally.⁸ Their courses can help supervisory staff, especially at the junior level, to acquire basic knowledge of insurance principles, market practices, and administrative functions.

8. For more information, see the website of the Institute for Global Insurance Education: www.igie.org.

So far, very few structured training programs specifically address insurance supervision. The insurance core curriculum, however, provides the materials for such training. The availability of these materials makes it easier to provide structured learning opportunities for insurance supervisors.

Continuing education. To keep up with the times, ongoing training and retraining of key personnel are needed. Supervisors must keep up with insurance industry practices and levels of sophistication. Changing tools for supervisory surveillance influence the methods used. For example, companies may take more complex risks so long as they have appropriate risk management tools to keep track of exposure; the supervisor must have corresponding tools to monitor activity in time to step in before disaster strikes.

Developments outside the country also affect the supervisor's duties. More and more, it is necessary to gain experience abroad. Exchange of staff with foreign authorities, participation in international seminars, or secondment of staff to international organizations are useful means to achieve this target.

Whatever training activities are employed, they should be structured and coordinated. Whether they are seminars, external secondment, or formal courses, training opportunities should not be one-time events. They should have explicitly stated objectives, and the content should be documented so that the learning can be reinforced or replicated. With clearly stated objectives, training programs can be reserved for staff members at appropriate places in their career. They can also be scheduled in logical sequence, leading to further activities that build on the knowledge gained.

Another potential danger of highly selective training activities, such as secondment to an organization in another country, is that the participant may become isolated from colleagues as a result of this unique experience. Such employees are often attracted to other employment offers, and the supervisory authority loses the benefit of the training.

The "train-the-trainer" approach surmounts some of these problems. Staff members who have completed advanced training can present in-house programs to provide their more junior colleagues with cost-efficient and tailored training. For the initial participant, the process of transmitting knowledge to others reinforces the learning. It also links the content more directly to the concerns of the office. For other participants, it provides access to more remote knowledge.

The key is that training activities should be coordinated with overall human resource planning. Training represents an investment for both the authority and the employee. A career path approach recognizes these investments and commits each to their mutual goals. The authority pays for education and training on the expectation that trainees will serve within the authority for some future period of time. The authority also promises, at least implicitly, to make opportunities for advancement available as the employee acquires the necessary education and experience. Career path programs reduce staff turnover and help the authority to build staff for the future.

The impact of effective human resource development often shows most dramatically at the middle level of staff. Without a strategy to develop and retain staff, as junior members gain supervisory experience, they are prone to seek employment elsewhere, leaving a gap at the authority that is difficult to fill. For junior staff to move into that gap, it is important to have competent and caring middle-level managers who provide close guidance and coaching.

COMPENSATION AND MOTIVATION

To maintain an adequate staff, supervisory authorities must make their compensation systems attractive and equitable to both current and prospective employees. The compensation system should be designed to attract new employees, to retain existing employees, and to motivate the staff to excel. A well-designed performance appraisal system encourages employees to work more productively and with more satisfaction.

Governments often strive for equity among all civil servants by imposing rigid wage scales across the board. Supervisory authorities that must operate within these wage scales can have difficulty attracting qualified employees. In such situations, careful job analysis and performance appraisal can at least help to place each job at the proper place on the scale.

Since labor market conditions sometimes change quickly, frequent adjustments in compensation may be necessary. The authority should monitor wage levels elsewhere to make sure that its scale is not out of line. Positions requiring specialized expertise, in reinsurance or actuarial methods, for example, may go unfilled if the authority cannot approach the pay offered by other employers. The authority may not have to match other employers' pay scales, but the discrepancy cannot be too large without undermining the quality of the staff.

To retain existing employees, equity is crucial. If not related to clear distinctions of duties and responsibilities, wide differentials within the staff can undermine morale. Other frames of reference such as wage scales for other government agencies or for similar jobs in industry can also lead to perceptions of inequity. Individual circumstances also matter. An employee who has upgraded skills but not received a pay increase may leave at the first opportunity.

This example shows the relationship of compensation to motivation. If the authority wants its employees to upgrade their skills, it should reward them when they do. Ideally, performance appraisals, not merely seniority, should affect pay increases to the extent that legal and union constraints allow.

Although important, pay is not everything. Other selling points may help to attract people. Employees choose particular jobs for a variety of reasons, and the supervisory authority should take those reasons into account. Working for the supervisory authority may carry more prestige, for example. Supervisory work is a needed public service, and it contributes to the development of the country. It may be more interesting and

satisfying work than that available elsewhere, especially if the staff work effectively as a team. It provides a view of the industry that is not available in other contexts, and it can be an opportunity to enhance the employee's credentials for future employment elsewhere. Sometimes the working hours or the office location are more convenient. Sometimes an employee accepts lower pay for either noble or venial reasons. The supervisor should strive to inspire the former and control the latter.

OTHER PERSONNEL POLICIES

Competent and effective staff do not sprout automatically; they must be nurtured. The personnel policies of the supervisory authority create the environment for staff development. Professional expectations, methodical human resource planning, vigorous training and development, and equitable compensation systems work together to build good staff. The authority's other personnel policies should fit the same framework.

A good practice is to compile all personnel policies into a staff handbook and to provide an up-to-date copy to each new employee. Employee benefits, working hours, leave time, expense reimbursement, and a host of similar employee concerns can be spelled out. Developing consistent guidelines and communicating them in writing can avoid many potential problems.

The staff of the supervisory authority should also have a code of conduct. All staff members must take care that their conduct conforms to the public expectations of the authority. The code can be a valuable reminder in that regard. A code cannot anticipate every situation that might arise, but its existence combats the two main obstacles to ethical behavior: indifference and inadvertence.

An important part of that code should be explicit conflict-of-interest rules. As suggested earlier, these should include prohibitions on investments in insurers and other related financial entities, a declaration of major investment holdings, and limitations on the acceptance of gifts.

EXTERNAL SPECIALISTS

According to ICP 3, essential criteria r and s, the supervisory authority must be able to hire, contract, or retain the services of external specialists through outsourcing contracts, if necessary. In addition, the supervisory authority must be able to assess the competence of these specialists, monitor their performance, and ensure their independence from the supervised companies or other related parties.

Whether the supervisory authority chooses to employ external specialists depends on the circumstances. Normally, the authority has more control when it relies on its own employees. External experts may have little prior knowledge of supervisory functions; the supervisory authority has to explain its objectives and train them regarding

specific procedures. As a temporary expedient, outsourcing can be a valuable option. As a permanent solution, the long-term costs of outsourcing should be weighed against the cost of training internal staff.

Nevertheless, circumstances often require external specialists. In supervisory authorities that have not yet had the opportunity to develop sufficient internal staff, on-site inspections may be outsourced to external actuaries, auditors, and lawyers. In other cases, exceptional and highly sophisticated questions, such as an insurer's use of derivatives, may prompt the supervisory authority to seek additional expertise. In this case, the supervisor might employ a neutral party with special expertise on derivatives to analyze the insurer's position and advise the supervisor. If the expertise required is not available locally, the supervisory authority may need to retain foreign specialists.

When external specialists are required, the terms of their engagement should be prepared carefully. The deliverables and indicators of performance should be clearly defined. The outsourcing contract should state explicitly that the supervisory authority has the power to monitor the activities of the person or the organization to which the work will be outsourced. The contract must subject this person or organization to the same legal requirements as the supervisory staff. These requirements include professional conduct, avoidance of conflicts of interest, and protection of confidentiality.

Exercise

- 4. Another insurance supervisor says that training is not important because experienced supervisory personnel can always be hired simply by offering high salaries. Do you agree with this approach? Explain why or why not.**

G. Confidentiality

Persons employed or authorized by the supervisory authority as well as members of an administrative council or an insurance advisory body should not pass any confidential information obtained in connection with their activity to any other person or authority.

Confidential information is only known to a restricted group of persons, and the persons or organizations to which this information relates often have a legitimate interest in restricting access to it. For example, they may not want it known to their competitors. Information in this sense includes not only facts but also conclusions, opinions, or perspectives. It may relate to a supervised company or to third parties, such as intermediaries or service firms. Information transmitted in summary or aggregate form, where it is impossible to identify specific parties or companies, is not considered to be confidential.

This confidentiality requirement arises because the insurance company has to give all information requested to the supervisory authority. There is no way to withhold information. Otherwise insurance supervision would be impossible. The confidentiality requirement on the supervisor's side is a necessary corollary to the disclosure obligation on the insurer's side.

The supervisory authority should use confidential information only for the following purposes:

- Examining an application for a license of an insurer or intermediary
- Monitoring the activity of an insurer or intermediary
- Making and enforcing supervisory decisions, including sharing with other supervisory authorities, where appropriate (see ICP 5)
- Within the framework of an administrative procedure concerning remedies against supervisory decisions
- Within the framework of proceedings in courts and criminal prosecutions.

For investigations of money laundering and terrorist financing, other government enforcement agencies may be in control, and insurance supervisors must cooperate with them (see ICP 28).

It is generally considered appropriate that secrecy requirements not prohibit conveying information to the following entities, to the extent that they require the information to fulfill their duties:

- Criminal prosecutors or the competent courts for administrative fines or criminal courts
- Supervisory agencies for banks, insurers, or other financial institutions
- Central banks
- Agencies dealing with liquidation or insolvency proceedings over the assets of an insurer, a bank, or other financial institution

- Persons entrusted with the legal auditing of the accounts of insurers, banks, and other financial institutions as well as the authorities that supervise these persons
- Institutions that manage guarantee funds.

The confidentiality requirement should not prohibit the sharing of information with foreign supervisory authorities, if these are subject to secrecy to an equivalent extent. This also applies to the exchange of information with foreign courts, banking supervisors, and other authorities and persons mentioned above. Special rules are applicable in the member states of the European Union and the European Economic Area.

The supervisor has to ensure that the receiving supervisor will treat any information transmitted as confidential and use it only for supervisory purposes (ICP 5, criterion f). This means that the supervisor has to verify that the confidentiality requirements in the relevant legislation comply with ICP 5. Normally, the receiving supervisor's written confirmation should suffice.

Exercise

- 5. Each year, the supervisory authority publishes insurance market statistics in aggregate form, including premiums by class, claims payments, expenses, assets, and technical provisions. This information comes from the internal accounts of the supervised companies given only to the supervisory authority. Does this publication violate the authority's obligation to protect confidentiality?**

H. Conclusion

Insurance markets require supervision, not just in name but also in practice. To meet its responsibility, a supervisory authority must have the necessary tools and resources. According to ICP 3, these include a clear mission, adequate legal powers, operational independence and accountability, sufficient financial resources, enough competent staff, and the ability to handle confidential information.

A clear mission should follow from the definition of supervisory objectives in accord with ICP 2. The authority's mission statement guides its priorities, brings consistency to its policies, demonstrates its commitment to the public interest, and provides justification for its actions.

Adequate powers flow from the enabling law for the authority. The legislation that establishes the authority and defines its responsibilities should also grant it the powers needed to execute those responsibilities. These include authorization of insurers and intermediaries, the power to make rules and guidelines, the power to require reports, access to insurers' records and premises, the power to intervene in an insurer's operations, the power to impose sanctions and penalties, the power to accept and hold deposits, and the power to act in lieu of an insurer's management or as a receiver of its assets.

Independence and accountability are two sides of the same coin. The governance structure of the authority should guarantee both. To be credible, the authority must be free from political influence. Its appointment and dismissal procedures, its budget, and the reasons for its decisions should be as transparent as possible. The more confidence the public has in the authority, the greater the willingness to accept its independence.

Independence requires sufficient financial resources, commensurate with the size of the market. Funding arrangements that place the costs of supervision on the insurers diminish political influence over the authority's budget, but care must be taken to avoid reliance on the industry. The authority should budget its expenses on an annual basis and account for those expenses in published reports.

In addition to financial resources, the authority also needs human resources to carry out its functions. Since the shortage of supervisory personnel is nearly universal, the authority should devote special attention to human resource development. Its planning efforts, training activities, performance reviews, compensation arrangements, and other personnel policies should be linked and focused on building a competent staff to meet future needs.

Finally, insurance supervisors must have access to the confidential information of the insurers they supervise. This gives them the duty to protect the confidentiality of that information. They can use that information only for supervisory purposes, and they can transmit that information only for legitimate supervisory and legal purposes, according to strict guidelines.

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Appendix I. ICP 3: Supervisory Authority

ICP 3: Supervisory authority

The supervisory authority:

- Has adequate powers, legal protection, and financial resources to exercise its functions and powers
- Is operationally independent and accountable in the exercise of its functions and powers
- Hires, trains, and maintains sufficient staff with high professional standards
- Treats confidential information appropriately

Explanatory notes

3.1. The supervisory authority must be fully empowered to achieve its objectives. The principle therefore covers the following essential elements relating to a supervisory authority: its legal basis, independence and accountability, powers, financial resources, human resources, legal protection, and confidentiality.

3.2. Independence, accountability, transparency, and integrity interact and reinforce each other. Transparency is a vehicle for safeguarding independence, ensuring accountability, and establishing and safeguarding integrity.

3.3. To support the independence and integrity of the supervisors, there should be provisions for the legal protection of staff as well as clear rules for appointment and removal of the head of the supervisory authority. These should be publicly disclosed. The supervisory authority should be operationally independent from external political and commercial interference in the exercise of its functions and powers. Independence enhances the credibility and effectiveness of the supervisory process. The existence of an appeals mechanism through the courts helps to ensure that regulatory and supervisory decisions are made within the law consistently and are well reasoned.

3.4. It is important to define the relationship between the supervisory authority and the executive and judicial branches, including processes for sharing information, consultation, or approval with the relevant ministry and the manner in which the supervisory authority could be subject to judicial review. This might include establishing what information should be provided, how each entity should consult on matters of mutual interest, and when approval from relevant ministries is necessary.

Legal framework: Essential criteria

- a. The legislation identifies the authority (or authorities) responsible for the supervision of insurance entities.
- b. The legislation gives the supervisory authorities the power to issue and enforce rules by administrative means (refer to ICP 4, essential criterion a).
- c. The legislation grants sufficient powers for the effective discharge of supervisory responsibilities.

Independence and accountability: Essential and advanced criteria

ESSENTIAL CRITERIA

- d. The governance structure of the supervisory authority is clearly defined. Internal governance procedures necessary to ensure the integrity of supervisory operations, including internal audit arrangements, are in place.
- e. There are explicit procedures regarding the appointment and dismissal of the head and members of the governing body. When the head of an authority or the governing body is removed from office, the reasons are publicly disclosed.
- f. The institutional relationships between the supervisory authority and executive and the judiciary branches are clearly defined and transparent. Circumstances where executive overrides are allowed are specified.
- g. The supervisory authority and its staff are free from undue political, governmental, and industry interference in the performance of supervisory responsibilities.
- h. The supervisory authority is financed in a manner that does not undermine its independence from political, governmental, or industry bodies.
- i. The supervisory authority has discretion to allocate its resources in accordance with its mandate and objectives and the risks it perceives.
- j. The supervisory authority has transparent processes and procedures for making supervisory decisions. Supervisory decisions are demonstrably consistent.
- k. All material changes to the insurance legislation and supervisory practices are normally subject to prior consultations with market participants.

ADVANCED CRITERIA

l. Representatives of the supervisory authority publicly explain their policy objectives and report on their activities and performance in pursuing their objectives.

m. Subject to confidentiality considerations, information is provided publicly about problem or failed insurers, including information on official actions taken.

Powers: Essential criteria

n. When necessary, the supervisory authority has the power to take immediate action to achieve its objectives, especially to protect policyholders' interests (refer to ICP 4, essential criterion e).

Financial resources: Essential criteria

o. The supervisory authority has its own budget sufficient to enable it to conduct effective supervision. The supervisory authority is able to attract and retain highly skilled staff, hire outside experts as necessary, provide training, and rely upon an adequate supervisory infrastructure and tools.

p. The supervisory authority publishes audited financial statements on a regular basis.

Human resources and legal protection: Essential criteria

q. The supervisory authority and its staff

- Observe the highest professional standards
- Have the appropriate levels of skills and experience
- Have the necessary legal protection to protect them against lawsuits for actions taken in good faith while discharging their duties, provided they have not acted illegally
- Are adequately protected against the costs of defending their actions while discharging their duties
- Act with integrity.

Supervisory staff are subject to conflict-of-interest rules, such as prohibition on dealing in shares and investing in the companies they supervise. The supervisory authority establishes and enforces a code of conduct that applies to all staff members.

- r. The supervisory authority has the authority to hire, contract, or retain the services of external specialists through contracts or outsourcing arrangements if necessary.
- s. Where supervisory functions are outsourced to third parties, the supervisory authority is able to assess their competence, monitor their performance, and ensure their independence from the insurer or any other related party.

Confidentiality: Essential criteria

- t. The supervisory authority maintains appropriate safeguards for the protection of confidential information in its possession. Other than when required by law, or when requested by another supervisor who has a legitimate supervisory interest and the ability to uphold the confidentiality of the requested information, the supervisory authority denies requests for confidential information in its possession (refer to ICP 5).
- u. External specialists hired by the supervisory authority are subject to the same confidentiality and code-of-conduct requirements as the staff of the supervisory authority.

Appendix II. NAIC Model State Insurance Department Funding Bill

BE IT ENACTED BY THE STATE OF [insert state].

[adapt caption and formal portions to local requirements and statutes]

Section 1. Insurance Regulatory Trust Fund

- A. There is created in the State Treasury a trust fund designated “Insurance Regulatory Trust Fund” to which shall be credited all payments received on account of the following items:
- (1) All sums received under Section 2, Filing, license, and miscellaneous fees
 - (2) All sums received under Section 3, Insurer examination charges
 - (3) All sums received under Section 4, Insurance Regulatory Trust Fund investments
 - (4) All retaliatory fees imposed upon persons by the department as authorized by law.
- B. The monies so received and deposited in the Insurance Regulatory Trust Fund shall be appropriated only for use by the Department of Insurance to defray the expenses of the department in the discharge of its administrative and regulatory powers and duties as prescribed by law subject to the applicable laws relating to the appropriations of state funds and to the deposit and expenditure of state monies. The Department of Insurance shall be responsible for the proper expenditure of these monies as provided by law.
- C. Any cash balance in the Insurance Regulatory Trust Fund after all current fiscal year expenditures are met shall be carried forward in the Insurance Regulatory Trust Fund for the next succeeding fiscal year.

Section 2. Filing, license, and miscellaneous fees

[Option 1. The Department of Insurance shall collect in advance, and persons so served shall pay to it in advance, fees, license, and miscellaneous charges as follows:]

[Option 2. The department shall by rule establish and collect the following fees sufficient to cover both direct and indirect costs of the department:]

[Option 3. The Department of Insurance shall by rule establish and collect fees to cover both the direct and indirect costs of the department, except that the fees shall be for the following activities and shall not exceed the following amounts:]

- (1) Certificate of authority of insurer
 - (a) Filing application for original certificate of authority, including all documents required to be filed therewith, filing fee \$
 - (b) Reinstatement fee \$

- (2) Charter documents of insurer
 - (a) Filing articles of incorporation or other charter documents, other than at time of application for original certificate of authority, filing fee \$
 - (b) Filing amendment to articles of incorporation or charter, other than at time of application for original certificate of authority, filing fee \$
 - (c) Filing bylaws, when required, or amendments thereof, filing fee \$
 - (d) Filing agreement or merger or consolidation or articles of reorganization, filing fee \$
 - (e) Filing agreements of reinsurance \$

- (3) Annual license fee of insurer, each domestic insurer, foreign insurer, and alien insurer \$
- (4) Annual statement of insurer, (except when filed as part of application for original certificate of authority), filing fee \$
- (5) Property, marine, casualty, and surety insurance representative's regulation
 - (a) Agent's original license and biennial renewal or continuation thereof, each insurer appointment fee \$
 - (b) Solicitor's original license and biennial renewal or continuation thereof, appointment fee \$
 - (c) Nonresident agent's original license and biennial renewal or continuation thereof, license fee \$
 - (d) Service representatives, supervising, or managing general agent's original permit, and biennial renewal or continuation of permit, appointment fee \$

- (6) Life insurance agent's regulation
 - (a) Agent's license and biennial renewal or continuation thereof, each insurer appointment fee \$
 - (b) Nonresident agent's original license and biennial renewal or continuation thereof, each insurer appointment fee \$

- (7) Health insurance agent's regulation

- (a) Agent's license and biennial renewal or continuation thereof, each insurer appointment fee \$
 - (b) Nonresident agent's original license and biennial renewal or continuation thereof, each insurer appointment fee \$
- (8) All limited licenses as agent, as provided for in Section [], or for license as limited surety agent, bondsman, or runner, as defined in Section [], each agent and each insurer represented. Issuance of original license and biennial renewal or continuation thereof, each insurer appointment fee \$
 - (9) Insurance agency license fee \$
 - (10) Insurance broker license fee \$
 - (11) Surplus lines agent. Issuance of original license and biennial renewal or continuation thereof, license fee \$
 - (12) Adjuster's licenses and permits
 - (a) Adjuster's original license and biennial renewal or continuation thereof, license fee \$
 - (b) Nonresident adjuster's original license and biennial renewal or continuation thereof, license fee \$
 - (c) Emergency adjuster's permit, appointment fee \$
 - (d) Claims investigator's permit, appointment fee \$
 - (13) Consultant's original license and biennial renewal or continuation thereof, license fee \$
 - (14) Administrator's original license and biennial renewal or continuation thereof, license fee \$
 - (15) Filing for license or permit whether or not examination is required: application for filing, each filing, filing fee \$
 - (16) Fee to cover actual cost of credit report, when such report must be secured by department \$
 - (17) Temporary license as agent or adjustor, where expressly provided for, rate of fee for each month of the period for which the license is originally issued and for which the license is renewed or extended \$
 - (18) Reissuance, reinstatement, modification, or duplicate copy of any insurance representative license or permit fee \$
 - (19) Annual license fee of rating organization, each domestic or foreign organization \$
 - (20) Miscellaneous services
 - (a) Fee for copies of documents or records on file with the department, per page \$

- (b) Fee for each certificate of the department under its seal, authenticating any document or other instrument (other than a license, permit, or certificate of authority) \$
 - (c) Fee for preparing lists of agents, solicitors, adjusters, and other insurance representatives and for other miscellaneous services, such reasonable charges as may be fixed by the department \$
 - (d) Vending machines, as authorized under Section [], original license and biennial renewal or continuation thereof, each machine permit fee \$
- (21) Filing of policy forms, endorsements, riders, filing fee \$
- (22) Filing of rates, filing fee \$
- (23) Service of process, filing fee \$

Section 3. Examination charges and expenses

- A. Each insurer examined by the Department of Insurance as required by law, shall pay to the department the expenses of the examination at the rates adopted by the department. The rates shall be reasonably related to the direct and indirect costs of the examination, including but not limited to actual travel expenses, including hotel and other living expenses, compensation of the examiner and other person making the examination, and necessary attendant administrative costs of the department directly related to the examination and shall be paid by the examined insurer together with compensation upon presentation by the department to the insurer of a detailed account of such charges and expenses after a detailed statement has been filed by the examiner and approved by the department.
- B. The department is authorized to pay to the examiner or person making the examination out of the Insurance Regulatory Trust Fund actual travel expenses, including hotel and other living expense allowances, and compensation in accordance with the statement filed with the department by the examiner or other person, as provided in Subsection A, upon approval by the department.
- C. When not examining an insurer, the traveling expenses, per diem, and compensation for the examiners and other persons employed to make examinations, if approved, shall be paid out of monies budgeted for such purpose as regular employees, reimbursement for the traveling expenses and per diem to be at rates no more than as provided for other state employees.

Section 4. Insurance Regulatory Trust Fund investment

- A. It is the responsibility of the Department of Insurance, charged with the administration of the Insurance Regulatory Trust Fund, to make such monies available for investment as fully as is consistent with the cash requirements of the fund and to authorize investment of such monies by the agency having the constitutional or statutory power to make investments and reinvestments for and on behalf of any state agency.
- B. Monthly, and more often as circumstances require, the Department of Insurance shall notify the investing authority of the amount available for investment, and the monies shall be invested by the investing authority according to the laws relating to state investments. Notification shall include the name and number of the fund for which the investments are to be made and the life of the investment if the principal sum is to be required for meeting obligations.
- C. All earnings derived from these investments shall be paid into the Insurance Regulatory Trust Fund.

Section 5. Insurance Regulatory Trust Fund deficiency

Whenever there exists in the Insurance Regulatory Trust Fund a deficiency which would render the fund insufficient to meet the Department of Insurance funding requirements, the state's chief fiscal officer may order a transfer of monies from another fund in the State Treasury to the Insurance Regulatory Trust Fund in order to meet the deficiency without resorting to the necessity of borrowing money and paying interest thereon. The fund from which any money is transferred shall be repaid the amount transferred from it not later than the end of the fiscal year in which transfer is made, the date of repayment to be specified in the order of the state's chief fiscal officer.

Section 6. Appropriation and use of monies; transition period

Nothing in this bill shall prevent continuing the practice of paying any of the direct or indirect expenses incurred by the department, including but not limited to, those involving salaries, retirement, social security, and state-paid insurance premiums of state officers and employees, or any other expenses by appropriations from the General Revenue Fund. However, the General Revenue Fund shall be reimbursed for any such payments made on or after the effective date of this bill, as well as any money transferred to the Insurance Regulatory Trust Fund in connection with the initial funding of the Insurance Regulatory Trust Fund and shall be repaid by transfer from the Insurance

Regulatory Trust Fund to the General Revenue Fund no later than the end of the next fiscal year.

Legislative History (all references are to the Proceedings of the NAIC).
1983 Proc. II 16, 21, 118, 208, 210-213 (adopted).

Appendix III. Answer Key

Exercises

The following are some suggested responses to the exercises.

1. *The finance minister issues a regulation that sets the maximum interest rate that may be used when calculating technical provisions for life insurance. Do you see any problems for the effective supervision of life insurers operating in the country? If so, what are they?*

The interest rate used to calculate technical provisions is a critical factor in the supervision of life insurers. If it is too high, the provisions will be inadequate and the risk of insolvency increases. If the maximum interest rate is too low, insurers may be unwilling to supply the insurance the market demands. The finance minister might not appreciate the significance of this factor, complicating the effective supervision of life insurers. The finance minister might lack the technical expertise the issue requires, might be susceptible to political influence, or might simply be constrained in responding quickly to changing economic conditions. It is better for the insurance supervisor to exercise this responsibility directly, but in this situation the supervisor should at least make the best advice on the issue available to the finance minister.

2. *The finance minister oversees the supervisory authority. Due to the volatile capital market, the supervisory authority issues a circular letter warning insurance companies to exercise caution in equity investments. The finance minister directs the supervisory authority to rescind this warning because it might prompt the companies to sell shares, accelerating the collapse of the capital market. What can the supervisor do in this situation? Is it possible to supervise the companies properly? What might be the consequence for the minister?*

The country may be on the verge of a financial crisis, in which case the insurance supervisor must take special care to coordinate actions with other government authorities. The precedent, however, of overriding the supervisor's judgment on the solvency of insurers should not go unchallenged. This situation clearly calls for a candid dialog between the finance minister and the insurance supervisor, leading to agreement on a common position. Regardless of the public position on the issue, the insurance supervisor should monitor the financial situation of insurers with increased vigilance. Resolving the different perspectives privately rather than publicly will give the finance minister more credibility in dealing with the crisis.

- 3. The insurance supervisor supervises 11 insurance companies. Five of them are financially troubled and could be liquidated soon. The country's insurance law provides that the supervisory authority is financed by fees for licenses. What problem will the supervisor soon have? What solution might be found?*

If there is a sudden decrease in the number of insurers operating in the country, the funds available for the supervisory authority will also decrease. At the same time, the work load of the authority will increase because of the need to supervise the liquidations. This possibility is a good reason for the authority's budget to include a provision for contingencies.

- 4. Another insurance supervisor says that training is not important because experienced supervisory personnel can always be hired simply by offering high salaries. Do you agree with this approach? Explain why or why not.*

Offering higher salaries might be necessary on occasion to attract qualified experienced employees to a supervisory authority, but this approach addresses only immediate needs. The long-term availability of qualified personnel, having both insurance and supervisory expertise, also requires systematic training and development programs.

- 5. Each year the supervisory authority publishes in aggregate form insurance market statistics including premiums by class, claims payments, expenses, assets, and technical provisions. This information comes from the internal accounts of the supervised companies given only to the supervisory authority. Does this publication violate the authority's obligation to protect confidentiality?*

Aggregate market statistics do not violate confidentiality requirements because they do not disclose information about individual insurers. The data from individual insurers become indistinguishable when combined into aggregate market data. A possible exception can occur if only one insurer writes a particular class of insurance. If such cases arise, the authority may need to consider alternative presentations in the aggregate report.