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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GUIDANCE ON INSURANCE REGULATION AND SUPERVISION FOR EMERGING MARKET ECONOMIES

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Guidance on Insurance Regulation and Supervision for Emerging Market Economies
Report from IAIS Emerging Market Issues Committee

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I. General Introduction

The attached paper was prepared by the Emerging Markets Issues Committee of the IAIS. The aim of this paper is to promote the establishment, adoption and implementation of regulatory and supervisory guidance for insurance markets in emerging economies. The guidance describes the unique challenges specific to emerging market economies and specifies the measures to be taken in order to move from the current regulatory regimes to ones meeting the level of supervision described in the IAIS Insurance Standards, which are being prepared by the Technical Committee.

The paper consists of three main parts:

- roots of problems in insurance markets in emerging economies (general characteristics of insurance markets in emerging economies);
- measures to solve problems (guidance for sound insurance systems); and

- action plans (plans for implementing essential measures for insurance markets in emerging markets).

Some parts of the paper refer to the concepts and terminology used by the report of the G-10 Working Party on financial stability in emerging market economies; the twenty insurance guidelines for economies in transition (adopted at the Second East West OECD Conference on insurance organised in cooperation with the Polish government in Warsaw in April 1997), their related notes and Mr. Bellando's note distributed during the conference have provided important information.

II. Draft guidance on insurance regulation and supervision for emerging market economies

1. Background

This guidance was prepared on the basis of the discussion and conclusion in the Emerging Market Issues Committee held in February and May in 1997. As discussed in the meetings, insurance markets in emerging market economies have faced unique challenges as have other financial sectors in the economies. Instability of financial markets, including the insurance sector in emerging market economies could have an impact on global financial markets. Indeed, lack of clear guidance to foster sound insurance markets for the emerging market economies has slowed the reform of the insurance sector and aggravated their problems. Thus the Emerging Market Issues Committee and Education Committee of the IAIS, because of their unique role in the international insurance supervisors' society, decided to prepare guidance on insurance regulation and supervision for emerging market economies.

2. Aim and main contents

The aim of this paper is to promote the establishment, adoption and implementation of regulatory and supervisory guidance for insurance markets in emerging economies that will assist in establishing a sound and reliable insurance system. The guidance is intended for insurance supervisors of emerging market economies.

Draft guidelines on insurance supervision applicable to all insurance markets (the IAIS Insurance Standards) are presently being discussed by the Technical Committee of the IAIS. The guidance presented here describes the unique challenges specific to emerging market economies and specifies the general measures that can be taken in order to move from the current regulatory regimes to others that are settled in the IAIS Insurance Standards and that can improve their actual situation. In other words, the guidance is intended to confirm the principles of basic regulatory and supervisory issues and to indicate clearly a route for reaching the level of supervision of IAIS Insurance Standards, covering crucial issues for the stability of insurance markets in emerging market economies.

Without specific action, establishing principles and preparing guidance do not have any impact on the real market. Thus, the paper proposes at the end a strategy (action plan) to promote the development and implementation of the described measures in emerging market economies.

3. Premises

In order to achieve its aim, this report has been guided by the fundamental premises set out below:

1. Sound macroeconomic and structural policies are essential for insurance system stability in order to prevent or at least limit the emergence of serious market distortions. Without the stability of the economy as a whole and sound development of basic financial and legal infrastructure such as the banking, credit and tax systems, the sound development of the insurance industry will not be achieved. There must also be sufficient political and social consensus supporting the measures needed to establish and maintain sound insurance markets.

2. Ultimate responsibility for the policies chosen to strengthen insurance systems must lie with the national supervisors or regulators who have a strong interest in developing sound arrangements for these systems.

3. Insurance sector stability is only achieved when prudential standards are met and when markets operate competitively, professionally and transparently in an international environment, according to sound principles and practices that generate the relevant information and appropriate incentives.

4. The strengthening of the regulation and supervision framework in parallel with the slow and cautious introduction of liberalisation measures is essential for improving the efficiency of the insurance market. Liberalisation without attendant prudential regulations and supervisory measures merely fosters chaotic market situations. Emerging market economies need special consideration in this regard due to their particular economic and financial situations.

5. Although reforms are in many cases urgently required, it must be realised that insurance markets in emerging market economies differ widely from one another. It is indispensable that insurance system reform take into account the particular character of each country and be appropriately adapted. In addition, regulatory and supervisory frameworks have to be adapted on a regular basis in order to match changing conditions, perceptions and economic needs.

4. General characteristics of insurance markets in emerging economies

The instability of the insurance sector in emerging market economies can be attributed to a wide range of microeconomic and institutional failings. However, it is almost invariably in an unstable macroeconomic environment such as a high inflation rate, in the wake of major structural

transformations or as a result of serious distortions in the real economy, that these failings give way to more critical problems.

In general, problems begin with lax management within insurance companies. Poor internal controls and moral hazard, where owners lack the proper incentives to act prudently and to supervise managers, often cause institutional failures. A particular case in this regard may be that of state owned companies, where managers may be guided by objectives that are not compatible with sound financial practices, while at the same time they are shielded from any external discipline. Weaknesses in the legal framework compound the problems of lax management and weak corporate governance.

The market can play a crucial role in disciplining bad performers, but this function may not be performed satisfactorily in the presence of inadequate information or distorted incentives. Some of the governments in emerging market economies also tend to be very cautious to expose the insurance sector to market discipline.

Basic infrastructure shortcomings for establishment and maintenance of a sound insurance system (accounting systems, financial markets as well as a legislative framework) can aggravate matters by failing to identify problems and preventing them from being addressed in a comprehensive and timely manner.

Strong regulatory and supervisory arrangements (insurance supervisory authorities, prudential regulations) that complement and support the operation of market discipline are indispensable to the stability of insurance markets. However, in the absence of effective market discipline, the entire burden of external control falls on insurance supervisors who may not have the requisite capacity.

The crucial issue for a robust insurance system is the development of a capable, professional cadre of insurers and supervisors. However, basic manuals for this purpose, particularly for training manuals for supervisors, have not yet been properly developed and training programmes are often not systematically arranged.

5. Guidance for sound insurance systems in emerging market economies

5.1 Creation of the essential infrastructure for effective market functioning

5.1.1 Legislation

Insurance legislation is essential to establish a sound and robust insurance system. Other legislation indispensable to the insurance sector such as commercial code, civil code, company law, tax law, banking law, should also be established at the same time. A legal environment should be fostered in any case. High quality insurance regulations and standards assure market participants that sound practices are being applied, thereby increasing market transparency and confidence. Although all

economies should periodically revise and update legislation to meet new market realities, emerging market economies face a particular challenge in developing a legal system suitable to a market environment, given the rapidly changing economic conditions and in some cases, the heritage of extensive state involvement in economic decisions. Frameworks based on industrial country models have proved useful but must still be adapted to the particular environment of emerging market economies and altered as those systems evolve.

A comprehensive set of prudential regulations and standards is indispensable if insurance supervisory authorities are to exercise their powers and responsibilities in a coherent fashion. The regulations and standards should be objective, internally consistent, transparent and clearly understood by those to whom they are applied.

5.1.2 Accounting principles and the role of actuaries and auditors

Accounting systems are central to the provision of the information needed by investors, consumers, managers, supervisors and other interested parties with an actual or potential stake in an enterprise so that they can make reasonable assessments of the effectiveness of the enterprise's operations and assess its future prospects. High quality accounting systems, taking into account the particular nature of the insurance sector, provide authorities with the practical means to perform proper audits, while at the same time are a vital resource for the management of companies and other interested parties. Indeed, insurance legislation can only play its intended role where effective information exists for its enforcement. Ensuring that the supervisory authorities have regular access to reliable information about insurance companies is a crucial issue for emerging markets since a lack of this mechanism have often delayed the discovery of financial problems in insurance companies and has therefore failed to prevent many of them going bankrupt.

Accounting methods should provide a real picture of economic gains and losses. The accounting system should establish rules that are to be applied uniformly to all insurance companies and are compatible with internationally accepted accounting standards. Not only should each accounting item be clearly defined but also the precise evaluation method should be stated in the regulations so that the financial condition of a company can be disclosed without any ambiguity. The information provided should be accurate, relevant and transparent. The information should also be comprehensive, timely and provided to the relevant parties on a regular basis.

Auditing provided by chartered accountants, independent, officially recognised and with a deontology code is vital to ensuring that accounting norms for insurance businesses are effectively applied and maintained, and to monitor the quality of internal control procedures. Internal auditing is vital to monitor the quality of internal control procedures. An actuarial system might be established that covers at a minimum, valuation of the liabilities of life insurance businesses, valuation of the assets corresponding to liabilities and the amount of the required solvency margin of life insurance businesses. Both internal and external audits are necessary and these constitute important complements to the assessment of insurance companies by the insurance supervisor.

5.1.3 Reliable data base

Availability of reliable basic data is also essential for effective market discipline. In particular, insurance premiums are calculated on the basis of the law of large numbers. For this reason, establishment of reliable policy data such as loss frequency and loss severity is indispensable in calculating correct insurance premiums and the technical provisions that are crucial for maintaining the solvency of insurance companies and for establishing the stability of insurance markets. Reliable mortality tables are also essential for life insurance products. In many cases of emerging market economies, an insurance company does not have enough past insurance policies to create a reliable data basis or a data collecting system itself has not yet been properly established. Thus the collection of claims data through cooperation of insurers should be encouraged. The insurance supervisory authorities should also establish a reliable claims database that will help insurers and supervisors confirm the right price for various categories of products.

5.2 Creation of the insurance supervisory authority

5.2.1 Creation of the insurance supervisory authority

Insurance legislation and reliable information can play their proper role only if an enforcement body i.e., an insurance supervisory body is established and functions effectively.

Therefore, the insurance supervisory authority should:

- have the power to license insurance companies, apply prudential regulations, conduct consolidated supervision, obtain and independently verify relevant information, engage in remedial action and execute portfolio transfer, and apply sanctions against insurance companies which do not follow the recommendations and injunctions of the supervisory authorities (i.e., restrict the business activities of a company, direct a company to stop practices that are unsafe or unsound or take action to remedy an unsafe or unsound business practice with the option to invoke other sanctions on a company or any business operation);

- be independent from both political authorities and controlled companies in the daily execution of supervisory tasks and be accountable in the use of its powers and resources to pursue clearly defined objectives;

- have broad and ample knowledge and experience ranging from actuarial science to contract law drawn from wide experience;

- have a reliable and stable source of funding to safeguard its independence and effectiveness;

- have the powers and sufficient resources to co-operate and exchange information with other authorities both at home and abroad thereby supporting consolidated supervision; and

- establish an employment system to hire, train and maintain a professionally qualified staff.

At the same time, the insurance supervisory authority must be bound to strict professional secrecy and the legislation must exclude any arbitrary intervention of the administration. Except the cases stipulated in law, the insurance supervisor may under no circumstances interfere in the management of insurance companies: the company's management being the only party liable for the decision it makes within the framework of the mandate conferred upon it by the owners of the company.

The supervisory authority should establish good cooperation and co-ordination schemes with other related government bodies or insurance institutions, such as ministries, tax offices or insurance guaranteed funds so that the given tasks are properly carried out.

5.2.2 Private market arrangements

The insurance industry should be encouraged to set up private mechanisms and institutions for the application of business guidelines and a code of conduct to limit detrimental practices. Self-regulatory principles and organisations, including professional bodies can be a useful complement to the public supervisory structure. However, supervisory authorities need to scrutinise such arrangements in order to ensure that they promote effective market functioning.

5.3 Promotion of the market mechanism

5.3.1 Information disclosure

It is important to improve the quality, timeliness and relevance of standards for disclosure of key information needed for credit and investment decisions in the interest of stakeholders (interested parties). Ensuring information disclosure is also essential for consumers to be able to select appropriate insurance products from the right insurance company. The most important information concerns the financial condition of an insurance company, the nature of its insurance products and the character of an insurance intermediary.

5.3.2 Foundations for good institutional governance

The foundation for good institutional governance is sound business strategy along with competent and responsible management. Insurance companies should be encouraged to develop an ownership structure that fosters stakeholder oversight. Private ownership of insurance companies is essential for strengthening the monitoring of management performance and reducing distortions in incentives and avoiding political interference in management. Privatised insurance companies should be established on a sound financial basis and with diverse ownership.

Good institutional governance of insurance companies requires comprehensive internal control procedures and policies that are implemented by skilled personnel and carefully monitored by management. Even capable management is liable to commit errors in fulfilment of its duties. Thus effective risk management of insurance companies is crucial. Insurance companies should have effective means to measure, monitor and control the various risks they face.

5.3.3 Promotion of competitiveness that is subject to essential prudential safeguards

Reforms leading to a market economy, particularly competition and liberalisation measures, are expected to promote entrepreneurial freedom, responsibility and accountability, optimise allocation of resources, increase efficiency and bring a better match between supply and demand and ultimately better quality services at reasonable prices. Subject to prudential regulations and supervision being met, competition in the insurance sector should be fostered by removing unnecessary restrictions and allowing participation of sound insurance companies in the insurance market. In particular, establishment of foreign insurance companies should be based on prudential but non-discriminatory rules.

5.4 Prudential supervisory and regulatory measures

Due to the high risk (insurance risk, investment risk, credit risk) environments in emerging market economies combined with limited experience and expertise, prudential regulations should be given particular emphasis.

5.4.1 Licensing and changes in control

Starting an insurance business requires a considerable amount of capital, special expertise, reliable management and an elaborate business strategy. For this reason, in most jurisdictions, it is a legislative requirement that those companies wishing to transact business in the domestic insurance market be licensed. In effect, licensing control is the main supervisory means by which unsound insurance companies are prevented from entering the market. This means that supervisory authorities can concentrate more on preventive measures against any financial difficulties rather than spend considerable energy and time dealing with insurance companies that are in trouble.

In emerging market economies, lax licensing control often allows undercapitalised and poorly managed insurance companies to enter the market and subsequently suffer from financial problems. Therefore, sufficiently strict licensing criteria should in particular govern the establishment of insurance companies. Examination of the nature and adequacy of the financial resources of insurance companies through analysis of business plans and the requirement for a relevant minimum level of capital deserves particular consideration. The supervisor should also consider the suitability of owners, directors and/or senior management. The insurance supervisor should also review changes in the control of companies and establish clear requirements to be met when a change in control occurs. These may be the same as or similar to the requirements which apply in granting a license.

The underwriting of insurance risks should be restricted to insurance companies which may transact insurance operations only. Life and non-life insurance operations should be separated, so that one activity cannot be required to support the other. Reinsurance companies and direct insurance companies should also be separated at the initial stage in emerging market economies.

5.4.2 Ongoing supervision

a. Practice on supervision, in particular on-site inspection

Insurance supervision should be exercised over the entire operations of the insurance company undergoing control and should involve various aspects, such as moral, legal, technical and financial. The insurance supervisor should in particular ensure that insurance companies are observing the regulations applicable to insurance. More specifically, the insurance supervisor should ensure that insurance companies:

- meet the contractual commitments made toward the insured (legal control); and
- are at all times in a sound financial position so as to meet their commitments (solvency control).

In order to achieve this, the insurance supervisor should examine not only the financial position of an insurance company at a given moment but also its operating conditions that determine its future financial position. Indeed the aim of insurance supervision is not to check whether a company was solvent at the date of its last financial report but to assess its ability to meet its commitments in the future.

In order to conduct the preventive control, regular contact with insurance management and thorough understanding of the insurer's operations are essential. There must be a means for independently and reliably verifying information reported or disclosed, in particular, the adequacy of technical provisions and asset valuations. On-site inspections are particularly important in allowing a supervisory authority to evaluate a management's effectiveness and its compliance with supervisory standards in those markets where weaknesses in accounting or reporting systems impair the effectiveness of off-site inspections. On-site inspection and off-site inspection of the same company should in principle be performed by the same person or group so as to ensure rational use of the information provided and supervisory powers. On-site inspections should cover all the factors which may sooner or later have an impact on the performance of the insurance company and thus on its financial position, i.e., control over the sales network, rating system policy, follow-up of claims and of results, risk selection, administrative organisation, financial management, efficiency of reinsurance, internal control, etc. These observations are essential in the assessment both of the skills and efficiency of the managers of an insurance company and of its capital requirements. A certain reliance could be placed on external auditors or actuaries only if a well developed auditing and actuarial profession exists and where auditors and actuaries are fully accountable.

b. Liabilities

The setting aside of liability, particularly technical (mathematical) provisions in an amount sufficient to meet at all times the company's commitments vis-à-vis the insured is at the very core of insurance business. However, calculating the proper level of technical provisions is indeed a challenge both for the insurance companies and for the insurance supervisor in emerging market economies. Inadequacy of technical provisions often cause financial difficulties or insolvency of insurance companies.

Inadequacy of technical provisions may be due to several factors: lack of legislative and practical measures on technical provisions, lack of historical data, uncertain economic conditions particularly a high inflation rate, an inadequate premium rate and a lack of professionals such as actuaries and auditors.

Introduction of appropriate legislation and monitoring measures is the first step to be taken. Insurance supervisors should establish standards with respect to the liabilities of companies. In developing the standards, the insurance supervisor should consider:

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

In addition, the accumulation of expertise both in supervisory authorities and in insurance companies should be encouraged. Data should be established that help evaluate sufficiency of technical provisions. The technical interest rate should be regulated in proportion to the general economic situation. The supervisor should monitor premium levels in order to avoid under-priced products. Professionals such as actuaries and auditors should be encouraged to be developed.

c. Assets

Technical provisions must at all times be backed up by equivalent assets that belong in full to the insurance company and are set aside to guarantee its commitments. Policyholders should have a preferential claim on the assets of the insurer in case of liquidation. In order to ensure the safety , profitability and liquidity of its investments, the insurance company must ensure that its investments are sufficiently diversified and dispersed.

Emerging market economies often suffer from limited investment opportunities, highly volatile capital markets, limited investment management and unadapted evaluation measures. Information on the financial markets is often not transparent. In addition, where stakeholder discipline mechanisms are poorly developed, competition is limited or historical circumstances have retarded the development of strong risk management as an institutional governance priority, the regulatory framework needs to pay special attention to insurance companies' procedures for assessing and managing all risks including credit risk (exposure to loss as a result of default on an instrument) and market risk (exposure to price change).

Prudential investment rules should be implemented that take into account the reality of markets. Insurance supervisors should establish standards with respect to the assets of insurance companies. These standards should address:

- diversification by type;
- any limits or restrictions on the amount that may be invested in financial instruments, property and receivables;
- the basis for valuing assets which are included in the financial reports;
- the manner in which those assets are held, such as self keeping assets; and
- appropriate matching and liquidity.

In addition, admissibility of the value placed on assets for the backing up of technical provisions by equivalent assets, or solvency margin requirements may be stated in regulations. It would also be appropriate for the value of unlisted assets and real estate to be certified by independent professionals.

Investment regulations on insurance should be co-ordinated with the regulations in other financial sectors so that they do not unbalance competition and hold back the sound development of the whole financial sector.

Emerging market economies tend to adopt highly restrictive rules on investment abroad. This is understandable for countries which have severe foreign currency reserve constraints. Also it is appropriate to follow the principle of currency matching in order to ensure protection from exchange rate risks. On the other hand, investments abroad can provide access to a healthy diversified portfolio and long-term investments tool, which are sometimes difficult to find in emerging market economies. Since fostering national investments also helps to finance the national economy, and on the other hand, investments abroad may reduce the risk linked to the inflation rate, then the investment policy abroad should be gradually liberalised at the same time as prudential regulations are introduced.

d. Capital adequacy

Both in the licensing process and in ongoing supervision, the insurance supervisor needs to pay particular attention to capital adequacy. The capital base (solvency margin) means the financial sources (margin) that work as a buffer against the possible adverse development of liabilities and other adverse circumstances such as changes in the litigation system, unexpected expense overruns, etc. Thus it provides information on the financial standing of the company and alerts supervisors to take any necessary action to protect policyholders. The requirements regarding the capital to be maintained by insurance companies should be clearly defined and address:

- minimum levels of capital or the levels of deposits (these levels concern only local branches of foreign insurers) that should be maintained. Capital adequacy requirements should reflect the size and business risks of the insurance company; and
- the process for valuing capital should reflect the requirements for valuing both assets and liabilities

The capital base is only an instrument for measuring and monitoring solvency. It should not be deemed by the management or the supervisor to be the end-result of asset liability management or a fail-safe index of the financial soundness of the company concerned. Adequate tarification and technical provisions covered by sufficient assets remain the main pillars of solvency.

e. Reinsurance

Adequate and effective reinsurance enables insurance companies to share risks with others, and to maintain stable underwriting results by spreading risks. In emerging markets, many insurance companies are still struggling to increase their capital base in order to establish sound financial conditions. A reinsurer's strong capital base can assist the business development of such insurers. High quality reinsurers also provide direct insurers with essential technical knowledge on insurance and reinsurance. At the same time however, in emerging market economies, reinsurance is a new activity for insurance companies which often suffer unsuitable reinsurance contracts or transactions with financially unstable reinsurers. In some cases, insurance companies use reinsurance contracts only as a means of cash transfer abroad.

For this reason, reinsurance transactions, in emerging markets in particular, should be closely monitored. The supervisor must be able to review reinsurance arrangements to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them. A method for the collection and monitoring of information relating to reinsurance companies should be established. International cooperation is particularly important in obtaining accurate information and this should be developed.

At the same time regulatory intervention of reinsurance placement should not be abused. Only through liberal access to the wider international reinsurance market can both the ceding and accepting companies be assured of providing and obtaining the best product and service at a competitive price. Compulsory cession of risks to local reinsurers, domestic market or discriminatory tax regimes against foreign reinsurance placement should therefore be avoided.

f. Control of product and tariff

Rates of insurance products should be adequate, not excessive and not discriminatory. In emerging market economies however, the lack of experience in insurance management, combined with the shortage of basic statistical data such as the frequency and severity of losses, make it difficult to set appropriate rates based on actual risk exposure. A considerable number of policyholders have suffered due to bankruptcies of insurance companies which were often caused by under-pricing. Information asymmetry between insurers and consumers is even greater in emerging markets due to insufficient disclosure of information on products and companies. It is difficult for prudent companies to compete against others that charge prices lower than cost in order to gain market share. Thus, initially at least, it may be appropriate for emerging market economies to request submission of premium rates to insurance supervisory authorities for prior approval.

Similarly, it may be preferable that the insurance products offered for sale be examined by the supervisory authority so that those seeking insurance will not be harmed by inappropriate policy conditions.

Supervision of tariffs and products should however be adapted to the particular situation of each country and reassessed at a later stage according to the development and progress of the market.

g. Intermediaries

Intermediary systems play a key role in consumers benefiting from a market oriented economy and thus choosing the best suitable products from a wide product range. The importance of properly controlled insurance intermediaries may be particularly relevant in emerging market economies where abuses in the distribution network are often observed that cause considerable problems for policyholders. Normally, insurance legislation distinguishes between brokers who represent the buyer and generally work with several companies to provide the best coverage for their clients, from agents or direct sales who represent the seller(s). Regulations on intermediaries should clearly state the scope of business and rights and responsibilities of intermediaries.

Supervision of intermediaries could take a variety of alternative or complementary forms. It can be carried out under the insurance supervisory authorities or through an independent body or industry organisation.

Insurance intermediaries should be registered or be required to obtain authorisation prior to commencing their operations. Insurance intermediaries should possess professional qualifications that prove general, commercial and professional knowledge and ability to ensure that consumers are protected. Insurance brokers are liable to their clients and thus should possess either financial guarantees or professional liability insurance or both, for the purpose of policyholder protection and of maintaining a sound intermediary system. Insurance intermediaries should disclose to their clients their status and provide extensive information on and comprehensive explanations of insurance products to policyholders.

h. Compulsory insurance

Compulsory insurance may be justified in respect of certain forms of social protection and might be considered in other areas where the risks covered are particularly serious and are not covered on a non- compulsory basis. Premium payments should be divided on an equitable basis among the policyholder group under consideration. Compulsory insurance is particularly recommended for automobile third party liability. Some emerging market economies do not have functioning compulsory third party automobile insurance, even though automobile accidents are frequent and victims are often not sufficiently compensated.

In order to establish a properly functioning compulsory insurance system, a suitable monitoring system is crucial for ensuring that all relevant parties have insurance contract. For this purpose, a penalty system for those who breach obligations could be set up. A guarantee funds system could be created to compensate victims in cases where there is no insurance cover. Tariffs for compulsory

insurance should also be based on statistical data. Underwriting compulsory insurance should not be limited to particular companies such as (former) state monopolies.

5.4.3 Remedial correction of problems

a. Remedial procedures

Even in well-controlled insurance markets, it may happen that a company confronts financial difficulties that lead to insolvency. For this reason, there should be well formulated policies for achieving corrective action and in cases where an institution is not viable as a going concern, orderly exit policies are essential to effectively exercise insurance supervision. Of particular importance in this context are remedial (going from preventive recovery measures up to sanctions) to deal with the financial problems of individual insurance companies. Clear instructions on this matter should be defined in legislation, covering matters connected with the management of troubled companies including: the standards applied in monitoring insolvency, the basis for being able to do a reorganisation by restoring solvency, available recovery measures, the revocation of licences, conditions under which the portfolio of insurance policies may be transferred to a sound company, the role of the liquidator and the ranking of creditors' claims. Because long delay can magnify the cost of resolving a crisis, it is of great benefit to have available concrete procedures for prompt corrective actions. Permanent supervision focused on preventive control through on-site and off-site inspection will play a key role for this purpose. Corrective procedures based on rules can help to reduce political pressures for undue forbearance.

At the same time however, authorities need to retain sufficient discretion to be able to deal flexibly with problems that arise and be able to adapt the means for dealing with problem insurance companies to market circumstances.

b. Design and application of safety net arrangements

Protection of policyholders and the high cost of a possible collapse of the insurance system are principal reasons why in certain countries, the supervisor provides a safety net (guarantee funds). Under certain conditions and particularly if the domestic market comprises a sufficient number of potential contributors with a broad spread of risks, creation of a safety net could be considered. However, such an arrangement inevitably creates moral hazards because it holds the prospect that stakeholders will be at least partially indemnified from losses caused by failing institutions. In order to minimise the moral hazard, it is essential to design and apply safety net arrangements in which the incentives of stakeholders to exercise oversight and to act prudently are not undermined.

6. Developing essential measures for insurance markets in emerging economies

The IAIS, in particular, the Emerging Market Issues Committee and the Education Committee will play a key role in promoting and fostering the principles and measures mentioned above.

6.1 Developing guidance on regulation and supervision of emerging market economies

Currently there is no comprehensive practical and concrete text which describes measures on legislation and supervision in detail for assisting in fostering a sound insurance system in emerging market economies, although it is indispensable during the process of introducing a new insurance system or of amending the current regulations or insurance supervisory system.

Thus the Emerging Market Issues Committee of the IAIS will develop a practical and concrete text for insurance legislation and supervision in order to help those economies to implement the principles and best practice established (or going to be established) by the Technical Committee. Such an exercise will provide other aspects on insurance supervision and would eventually contribute to the activities of the Technical Committee.

This exercise will take the following steps:

- collect relevant materials from member countries and international organisations such as the Basle Committee, IOSCO, OECD and UNCTAD on the practical measures for implementing sound supervision. Close cooperation with the Laws and Regulations Committee will be useful;
- determine priorities on supervisory issues for emerging market economies;
- draft concrete analysis on the issues which require priority; and
- guidance will be drafted by a small task force made up of members of the Emerging Market Issues Committee and Educational Committee and the prepared draft will be discussed in both Committees.

6.2 Implementing sound principles and standards in emerging market economies

6.2.1 Training and seminars

The effectiveness of a supervisory body depends mainly on the human resources at its disposal. Taking into account the shortage of qualified staff and proper resource development strategies, well organised training schemes for supervisors are crucial to the emerging market economies. Training for supervisors should consist of both theoretical and practical aspects and of both legislative and supervisory aspects. It should not be a single event but should be conducted continuously and be based on well arranged programmes. However, at the moment, training courses, materials and methods for supervisory staff are not arranged systematically in many cases.

Within this process, an active role of the recipient countries should be particularly encouraged so as to ensure that training addresses their needs.

The training programmes for insurance supervisors in emerging market economies drafted by Mr. Bellando, the Chairman of the Education Committee of the IAIS are to:

- organise supervisory training by geographical area (Africa, Central and South America, Asia, East European countries);
- organise a total of four training programmes in two years, i.e. one for each geographical area;
- the themes of the training programmes will be determined on the basis of both the results of the survey made by the Emerging Markets Committee and the main sections of the Manual (licensing, control and supervision, investments, solvency);
- each organiser will contact the countries in his/her zone and the competent regional organisations. He/she will settle the plan, duration, language and location of the training. He/she will report back to the Education Committee;
- funding will be determined by the Education Committee in consultation with the Emerging Market Issues Committee; and
- some training could be organised in cooperation with the national or international organisations.

As suggested by Mr Molgaard (Denmark), the Committee should also consider organising missions to emerging market economies in order to:

- carry out the terms of reference of the Emerging Market Issues Committee and contribute to raising the level of both the insurance industry and the insurance market
- recruit more IAIS members;
- create a prototype for insurance industry supervision;
- develop know-how on technical assistance on the same lines as the extensive technical and financial support for the banking system; and
- establish a base for channelling technical assistance and financing from the industrial countries to the emerging market economies.

6.2.2 Coordination

The IAIS will also play a key role in co-ordinating technical assistance on insurance issues in emerging markets. Due to its large membership (in both industrial and emerging market economies) and its unique international role on insurance supervision, the IAIS is in an ideal position to be a central intermediary between organisations which provide technical assistance and users of technical assistance. Furthermore, the IAIS will also play a co-ordinating role in ensuring that technical assistance provided by various institutions is complementary. At present, the EU, OECD, UNCTAD and the World Bank as well as other international organisations, certain governments, academic

societies and private sector bodies, etc., all organise their own technical assistance programmes, training, seminars with limited co-ordination between them.

Therefore, the Emerging Market Issues Committee and the Education Committee will:

- further develop the results of the research prepared by Mr. Butterworth former Chairman of the Education Committee, concerning training requests and organisations which provided training;

- prepare and send a questionnaire on those providing technical assistance and requests for technical assistance to all IAIS member countries, non-IAIS member countries and international organisations under the initiative of Mr. Bellando, Chairman of the Education Committee; a questionnaire will cover questions on concrete assistance programmes, the possibility of financial assistance, name and address of the contact persons (organisations which provide training) and on results of using technical assistance including training courses, future needs for training and other technical assistance and suggested topics, etc., (training requirements);

- analyse the collected answers and assess the needs for assistance and possible organisations which provide assistance;

- nominate a person from the Education Committee to strengthen co-ordination between organisations which provide assistance and requests for assistance, between the IAIS and other organisations which provide technical assistance on insurance supervision. He/she will take the initiative in exchanging information and co-ordinating seminars or training programmes. He/she will foster bilateral exchange visits and studies for supervisors; and

- nominate a key person from each region to co-ordinate technical assistance programmes in that region.

6.3 Further development of guidance for insurance regulation for emerging market economies and their training programmes

The activities of the Emerging Market Issues Committee and the Education Committee is not static, but evolve and develop through experience. The experience and information obtained by seminars, training and missions will be utilised to further develop a practical text and measures for supervisors. The interaction between the text and training will be mutually beneficial, leading to the higher level of expertise in both fields.