



Insurance Governance and Risk Management

Rodney Lester and Oliver Reichart

PRIMER SERIES ON INSURANCE
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NON-BANK FINANCIAL
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GLOBAL CAPITAL MARKETS
DEVELOPMENT DEPARTMENT

FINANCIAL AND PRIVATE SECTOR
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THIS ISSUE

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The Primer Series on Insurance provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

The Non-Bank Financial Institutions Group in the Global Capital Markets Development Department aims to promote the healthy development of insurance, housing finance, and pension markets, and to expand access to a broad spectrum of financial services among the poor. These markets provide opportunities for household investment and long-term savings, and can buffer the poor against the risks of sickness, loss of breadwinner, catastrophic events, and other misfortunes.

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Contents

Abbreviations & Acronyms	iv
Policy basis of corporate governance	1
Corporate governance and the insurance sector	1
The elements of insurer risk management	5
Risk management practices	5
Risk management, internal audit and appointed (responsible) actuaries	7
Supervisory boards	9
Financial reporting	13
Supervisory agency	14
External audit	16
Annex I: Insurer governance in Australia	18
Annex II: Recommendations from World Bank EU accession country financial sector governance survey	20

Abbreviations & Acronyms

AA	Appointed Actuary
ADR	Alternative Dispute Resolution
COSO	Committee of Sponsoring Organizations of the Treadway Commission
EC	European Commission
EU	European Union
FCR	Financial Condition Report
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISA	International Standards of Auditing
NAS	National Accounting Standards
OECD	Organization for Economic Co-operation and Development
PA	Personal Accident
P&C	Property & Casualty

Insurer Governance and Risk Management

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Policy basis of corporate governance

A sound corporate governance framework ensures that insiders do not use their privileged position to the disadvantage of other stakeholders, notably small minority shareholders, creditors and in the case of insurance companies, policy-holders.

La Porta et al have noted that “the empirical evidence rejects the hypothesis that private contracting is sufficient”. In addition, they cite evidence that “insiders in major firms oppose corporate governance reform and the expansion of capital markets. Under the status quo, the existing firms can finance their own investment projects internally or through captive or closely connected banks. Poor corporate governance delivers the insiders not only secure finance, but also secure politics and markets. Thus they have an interest in keeping the system as it is.”¹ The main weapons in ensuring an equitable distribution of power and rights between the various stakeholders in an enterprise are judicially enforced law and government enforced regulation, supported by adequate levels of disclosure and transparency.

Corporate governance and the insurance sector

In the early stages of development, the insurance sector is often seen purely as a commercial enterprise. The primary insured parties are industrial firms and entrepreneurs. At this stage, relatively light regu-

¹ La Porta, Rafael et al., *Investor Protection: Origins, Consequences, Reform*, World Bank, 1999

lation and oversight of the insurance companies is all that is needed. However the situation changes once compulsory classes of insurance are introduced. When motor third party liability insurance is required for all automobile drivers and major liability classes of business have been introduced, the public at large starts to rely on insurers for significant sums of money in the event of an accident or tort. At this stage, high standards of governance of insurance become necessary. The stakes rise further when life insurance and pensions become common and the public invests its long-term savings, including retirement incomes funds. At this latest stage, the government has an obligation to ensure that insurers and pension providers follow high standards of corporate governance, and risk management in particular.

The establishment of adequate technical provisions and reserves is a critical element of sound insurance risk management. For life insurers the calculations are based on complex assumptions involving mortality rates, allowance for future expenses, lapse and discontinuance rates and future investment yields. As a result, standard corporate accounting and financial reporting make it difficult to gain appropriate insights into the financial position of a life insurer. Insurance policy-holders are thus largely dependent on the ability of management and the supervisory board to take conservative and prudent risks and have sound capital management policies. In addition policy-holders depend on the willingness and ability of shareholders to contribute additional capital when needed.

Strong governance in the insurance sector requires two lines of defense. The first line of defense consists of the internal organs of the company—its management, the systems of risk management, internal audit and internal controls, the company's actuary and the supervisory board that should have oversight of them all. External measures provide the second line of defense. These cover both the supervising authority that oversees the insurance companies and market mechanisms that monitor and influence the sector. Both lines of defense are needed to ensure a high level of transparency and accountability in the sector. Furthermore the burden on the supervisory authority is significantly reduced if the companies' internal governance arrangements are strong, or where the market provides an effective form of discipline through enhanced levels of transparency and signaling.

In practice, World Bank/ IMF financial sector assessments carried out under the FSAP Program established after the 1997/99 financial crisis have found that corporate governance is one of the insurance core principles (ICPs) most commonly receiving poor ratings. Consistent with this, the increasing employment of guarantee funds to backstop private sector mechanisms attests to the social costs of failure of gover-

nance in the insurance sector. Accordingly the corporate governance of insurers is increasingly becoming concerned with the management of risk in addition to the traditional preoccupation with accounting, audit, managerial appointments and strategic issues.

Robust risk management requires two elements. Firstly, insurers must maintain sufficient technical resources and capital commensurate with the company's risk position and profile. Secondly, the governance structure must take into account the rights and interests of all stakeholders—and particularly policy-holders. In developed insurance markets the well regarded Canadian regulatory approach is often seen as the ideal. This has worked primarily through boards and senior management for more than a decade (arising from the governance failures in Confederation Life and some other smaller insurers in the 1980s) and heavily influenced the changes to the Australian regulatory regime introduced after the failure of HIH in 2001. More recently the Framework Directive introducing the Solvency II (SII) regime in the EU and approved in April 2009 places most risk and uncertainty on the back of insurers' access to capital and depends on companies' governance and risk management systems to get capital management right. The role of the supervisor under this regime will be to ensure that a company's governance and risk management approach is adequate. In extremis the supervisor will be able to require that capital is increased. The effectiveness of SII will be highly dependent on the availability of actuaries, highly trained financial staff and excellent information systems.

The US approach to date has been more rules based, incorporating a well defined and objective supervisory intervention procedure based on formulaic risk based capital and other ratios. However there is also an overriding power for the relevant supervisor(s) to intervene under the Hazardous Financial Condition Model Regulation. From 2010 this will incorporate supervisory assessment of an insurer's governance and risk management approaches.

A 2006 World Bank survey of (what were then eleven) EU accession countries identified four key weaknesses in insurance governance. These are also found in many other developing and transition (and a few highly developed) markets:

- 1) Actuaries are generally confined to fulfilling the role of the statistician who calculates solvency and reserves. They do not perform the additional statutory role of an "appointed actuary" whose duties should include the performance of an independent cross check on management. For insurance companies with long-dated obligations many years in the future, financial condition reports (FCRs) constitute the critical reports in which a qualified actuary

gives his/her opinion about the financial status and outlook of the insurer. However in none of the EU11 countries are appointed actuaries required to produce financial condition reports to western European standards. In seven of the EU11, no annual statement in any form is required from appointed actuaries. Furthermore, where they do submit reports, appointed actuaries file them only with the management boards and are not obliged to give submissions to the supervisory boards, or the sector's supervisory agency.

- 2) Internal auditors generally report only to the management board and do not have access to the supervisory board or the supervisory agency.
- 3) Supervisory boards are established in such a manner that they can only play a relatively minor role. Most supervisory boards among companies in the EU accession countries lacked independent directors who could provide a perspective independent from that of company insiders. With few exceptions, supervisory boards lacked the tools (in the form of audit or other committees) to ensure proper corporate governance compliance.
- 4) External reporting by insurers was generally confined to financial results and operating reports. Additional data which would cover corporate governance issues, such as disclosure of salary levels by individual board member, detailed disclosure of related party transactions or statements of independence by supervisory board members were not disclosed.

For their part, the supervisory agencies were also assessed as being constrained in their effectiveness:

- 1) Among the accession countries only Estonia fully used a risk-based supervision framework, and hence most of the surveyed countries were only partially equipped to manage industry risks in a timely fashion.
- 2) In five of the accession countries, the State retained equity interests in insurance companies, thus posing clear conflicts of interest and creating ambiguity of role for the supervisors.
- 3) Reporting to supervisory agencies by insurance companies was inadequate. In none of the accession countries did appointed actuaries or auditors have "whistle blowing" responsibilities to report to the supervisory agencies their concerns regarding long-term financial solvency.

Annex II lists the recommendations arising from the 2006 survey.

The elements of insurer risk management

Risk management practices

Robust corporate governance requires that an insurance company has a risk management framework which meets three goals: (1) identifies systemically all the risks facing the organization; (2) develops risk mitigation strategies and; (3) manages its risks in an ongoing manner. The framework needs to have warning mechanisms in place, so that when a serious risk matter arises (such as a failure to meet minimum solvency requirements) supervisory board members and supervisory agencies receive enough warning to take action and prevent bankruptcy. Good insurer governance involves the appointment of qualified and relatively independent oversight boards, implementation of risk management that is comprehensive and sees the whole corporate picture, internal audit departments that report independently from management, and appointed actuaries that are legally accountable for their actions and are also able to act independently when necessary.

Insurance boards and senior managers should be able to identify all risks, manage them in a specialized department, and monitor them through a dedicated risk manager. The internal auditor may report to the risk manager.

Eight distinct risks need to be managed by insurance companies.

- Insurance Risk

Insurance risk relates to the types of insurance products the company writes. Some products have a much lower insurance risk than others. For example, products involving many small policies such as household contents insurance are much less risky—systemic events excepted—than products which insure single large risks such as commercial buildings or multi million dollar life insurance policies. Similarly policies with a short duration during which claims can be made (for example, auto insurance) are much less risky than policies where claims can be made for a number of years after the insured event (for example, professional indemnity insurance.) The relative risks are reflected in varying levels of capital which the insurer needs to hold. The higher the risk, the greater amount of capital required to support those risks.

- Operational Risk

Operational risk refers to all the risks associated with the operating units of an insurance company, such as the underwriting, claims and investment departments. Each department has its own risks which must be managed. For example, when writing a high value life insurance contract, the underwriting department must accept (straight out or with exclusions), decline, or load (accept a risk but charge more for it) the application in accordance with strict internal guidelines. Cross-checks need to be in place to ensure that internal guidelines are duly followed.

- Liquidity Risk

The company must ensure that it can draw on sufficient cash to meet its liabilities, which are primarily payments of claims and benefits to policyholders. The company must have processes in place to convert investments and other assets into sufficient cash, as needed to meet its liabilities.

- Strategic Risk

Any strategic initiative carries risks, which must be identified and quantified. Corporate strategies can involve low risk levels (for example, remaining in the same market or distributing the existing product range) or they can involve elements of high risk (for example, purchasing a competitor or distributing a new and more risky product range.)

- Contagion and Related Party Risk

When an insurance company is a member of a large group of companies or a conglomerate, it is exposed to some of the risks of the group as a whole. In addition, under stress the owners of the group may divert capital and resources, including management, from the insurance company to other companies of the group. Such diversion may weaken the ability of the insurance company to meet its claims—or develop a long-term competitive strategy.

- Balance Sheet and Market Risk

Balance sheet and market risk relate to the strength of the company's balance sheet and the degree of risk inherent in the invest-

ment portfolio. Low risk assets include government bonds from OECD countries, whereas company shares may be associated with a high risk category. Risk levels are further influenced by the quality of individual investments as measured by credit ratings from independent ratings agencies.

- Counterparty Default Risk

Insurance companies rely on being paid by third parties, including the company's reinsurers and investment counterparties. Counterparties may not be able to pay their ongoing obligations (for example, interest on a corporate bond or rent by a lessee) or they may not be able to meet their obligations on time. Also an investment may not be convertible into cash despite a legal obligation to do so (for example, a redeemable preference share) or such conversion to cash may not occur within the contracted time frame.

- Legal and Regulatory Risk

Insurance companies run the legal risk of being sued for a denial of a claim. Insurers companies can take an aggressive stance on claims payments, leading to low claims payments and high litigation costs. Alternatively they may take a compliant position, which would lead to high claims payments but low litigation costs. Regulatory risk relates to the risk of the company's officers or its agents failing to comply with the rules of the industry regulator.

The "sub-prime" mortgage crisis and subsequent credit freeze, weaknesses in the markets for credit derivatives and collateralized debt obligations, and the subsequent impact on global financial institutions including insurance companies, have highlighted the need for robust risk management practices in all financial institutions. The importance of healthy levels of capital adequacy including safety margins have been reinforced: even if insurers were not directly invested in "sub prime" mortgage assets, the balance sheets of most insurance companies have been affected by the consequent significant reduction in the value of investment assets.

Risk management, internal audit and appointed (responsible) actuaries

The first step leading to strong corporate governance in the insurance sector lies with the establishment of a risk management department, an

internal audit department and appointed actuaries within each insurance company. All three functions should include “whistle blowing” duties to report to supervisory boards and supervisory agencies where serious corporate transgressions of law or regulation are identified. Risk management and audit departments have different roles to play. The risk management department sets up and monitors the company’s system of internal controls to ensure that company officials do not take actions that contradict the corporate risk policies. The role of the internal audit department, by contrast, is to verify that internal controls rules are followed.

Appointed actuaries play a vital role in the corporate governance regime of insurance companies, particularly for life insurers. They perform the specialist functions of product pricing and calculating reserves. However they should also prepare an annual “financial condition report” (FCR) to be submitted to company’s supervisory and management boards. Under SII the FCR may be usurped by a mandatory Own Risk and Solvency Assessment (ORSA) but it is likely that appointed actuary will have considerable input to this document. The FCR should go to the supervisory agency upon request. Only nine of the EU accession countries surveyed in 2006 required appointment of an actuary in insurance companies. Four countries obliged the appointed actuary to prepare an annual statement. In Poland, the actuary’s statement needs to be included in the published annual financial statements but the actuary is not legally required to prepare a detailed report. The actuary’s statement is generally submitted only to the company’s management board and the supervisory agency (and not to the company’s supervisory board). Only one country (the Czech Republic) required that the appointed actuary provide any sort of annual report to the company’s supervisory board. Not one country required that the appointed actuary prepare a full financial condition report (FCR) for the company management (or supervisory board or the supervisory agency). This is a common pattern in developing and emerging markets.

According to the Australian Prudential Regulation Authority, a FCR must provide an assessment of the key risks and issues impacting the financial condition of an insurer. This including providing the insurer with implications of issues identified and, where these implications are adverse, proposing recommendations designed to address the issues.² American Academy of Actuaries Standard No 19 also sets minimum requirements for a FCR.

2 See for example, the Guidance Note of the Australian Prudential Regulation Authority available at <http://www.apra.gov.au/Policy/upload/Draft-Prudential-Standards-General-Insurance-Risk-and-financial-management-GGN-310-1-Financial-Condition-Report.pdf>

Few countries have sufficient training and accreditation processes for actuaries. The training and certification of fully qualified actuaries (that is to achieve full membership status with the International Actuarial Association) typically takes between 5 and 7 years. All transition countries should encourage the local actuarial professions (and professional associations) to establish adequate levels of training given the local context, if necessary with support from foreign actuarial societies (as is already the case in Egypt, some Central and Eastern European countries and some Asian countries). Developing countries will in general be reliant on actuaries trained elsewhere.

Supervisory boards

The IAIS Core Principles highlight the importance of supervisory boards in corporate governance of insurance companies. They note,

“In most jurisdictions corporate governance rules exist for general purpose corporations; these likely also apply to insurers. Often, however, it is necessary to establish additional requirements, through insurance legislation, that deal with the matters of specific concern and importance to insurance supervisors. ... As the supervisory authority may not have the power to specify the details of general corporate governance rules or to enforce compliance, several criteria under this principle refer to the responsibility of the board of directors rather than requirements from the supervising authority.”³

According to the IAIS Core Principles, supervisory boards should have five roles:

- 1) The supervisory board satisfies itself that the insurer is organized in a way that promotes the effective and prudent management of the institution and the board’s oversight of that management. The supervisory board has in place and monitors independent risk management functions that monitor the risks related to the type of business undertaken. The supervisory board establishes audit functions, actuarial functions, strong internal controls and applicable checks and balances.⁴

³ Paragraph 9.3. IAIS Core Principles, October 2003

⁴ The EU has tried to overcome the problem of terminology relating to bicameral boards versus single boards by reference to a functional approach. Under the EU terminology, the supervisory board assumes ultimate responsibility and monitors that appropriate audit functions, actuarial functions, strong internal controls and applicable checks and balances are established.

- 2) The supervisory board is able to carry out its functions in an objective and equitable manner. The supervisory board has access to information about the insurer, and asks for and receives any additional information and analyses that it needs.
- 3) The supervisory board communicates with the supervisory authority as required and meets with the supervisory authority when requested.
- 4) The supervisory board identifies officer(s) with responsibility for ensuring compliance with relevant legislation and required standards of business conduct and who reports to the board at regular intervals.
- 5) When a “responsible actuary” is part of the supervising process, the actuary has direct access to the supervisory board or a committee of the board. The actuary reports relevant matters to the supervisory board on a timely basis.

The IAIS Core Principles make it clear that the supervisory board of directors performs a distinct overview role separately from the responsibilities of senior management of an insurer. The corporate governance codes of Germany and Austria,⁵ which emphasize the role of supervisory boards in major corporations, demonstrate that such responsibilities are entirely consistent with Civil Code systems. The EC’s Recommendation on the Role of Supervising Directors also highlights the importance of supervisory boards.

Supervisory boards should make significant contributions to the safeguarding of stakeholder and policy-holder interests. Following international good practice, they should operate according to six principles:

- 1) The supervisory board should have clear, well defined and well understood roles and responsibilities, including responsibility to approve the insurer’s strategic direction, to oversee management, and to take ultimate responsibility that the insurer is managed prudently.
- 2) Members of the supervisory board should have liability for actions taken, or not taken as a result of governance failure, that could harm the company.
- 3) The supervisory board should be chaired by a non-executive director (i.e. a non-executive of the insurer concerned) and include a majority of non-executive members and have a sufficient number of independent directors to serve on the relevant

5 See the 2003 German Corporate Governance Code (The Cromme Code) and the 2002 Austrian Code of Corporate Governance. Both can be downloaded http://www.ecgi.org/codes/all_codes.php.

supervisory board committees. Even closely-held insurance subsidiaries should have a minimum number of independent directors with specific responsibility to monitor related-party transactions, particularly with the parent company.

- 4) The supervisory board should establish and maintain committees to assist it in the performance of its roles. Such committees should, at a minimum, include an audit committee responsible for oversight of all matters related to internal audit and controls and external audits and review and approval of published financial accounts. The audit committee should ensure that the internal controls system meets the standards of COSO.⁶ The audit committee should ensure that the company's internal audit personnel have unimpeded access to the committee. The audit committee should receive regular reports from the company's internal audit department, including any material breaches of controls or limits.
- 5) Other desirable committees would include: (a) a risk management committee responsible for oversight of the insurer's systems and controls for monitoring and managing risks; and (b) a remuneration committee responsible for oversight of the remuneration and compensation arrangements for senior management.
- 6) The management of a foreign insurance subsidiary should be directly accountable to the supervisory board of the subsidiary, even if they have reporting responsibilities to the parent entity.

A review of publicly available information shows that the supervisory boards of Austrian insurers active in eastern and central Europe fulfill these roles.

In general, the supervisory boards of many developing and transition country insurance companies suffer from three key weaknesses:

- 1) They do not have a well defined function and in fact often fill only a ceremonial role.
- 2) They are not chaired by a non-executive director (i.e. a non-executive of the insurer concerned). They do not include a majority of non-executive members. Often they have one dominant individual making all key decisions.
- 3) They do not establish and maintain committees to assist it in the performance of its roles. In emerging markets, many larger insurers do maintain audit committees. However these have been

6 COSO refers to The Committee of Sponsoring Organizations of the Treadway Commission, which focuses on internal controls. The Committee was originally formed in the USA in 1985 to sponsor the National Commission on Fraudulent Financial Reporting.

operated by members of the management board rather than the supervisory board.

Some multinational insurers have elevated the importance of supervisory boards to fulfill functions in line with good corporate governance. Their objective, however, pertains to control of their operations, rather than the primary objective providing an independent cross-check on management as represented by the management board with the primary objective of safeguarding the interests of policyholders.

Committees provide an essential tool for effective supervisory boards. Independent members ensure that the committees bring a perspective different from that of company insiders.

Furthermore in most developing and transition countries, supervisory boards perform an ancillary function to the management board. This is perhaps best summarised by the supervisory board report of one of the major insurance companies in the EU accession countries.

“The Supervisory Board was kept informed of developments in sales and financial results and of the Company’s strategy, and accordingly was able to oversee the operations of the Company. The Supervisory Board reviewed and discussed the Company’s results for 2006 as reported in the financial statements and the auditor’s report...”

In this case, the supervisory board did not authorize corporate strategy of the insurance company (It was “kept informed”). Nor did the supervisory board authorize the accounts (It “reviewed” them). In the absence of specialized committees, the supervisory board also lacked the tools to adequately oversee a company’s operations.

One test of effective supervisory boards lies in how many board members are concerned over their personal liability of corporate actions—and how many take out insurance to protect their personal assets in case of a liability lawsuit. As the result of transposing the EU Directives, individual management and supervisory board members of EU accession insurance companies have personal liability for actions taken—or not taken as a result of governance failure—that could harm the company. Consequently, Western European directors sitting on boards of their EU accession country subsidiaries generally insist that directors’ and officers’ liability insurance be taken out, as is standard practice in Western Europe. However such insurance cover was not generally taken up on behalf of supervisory board members of local EU accession country insurers, who appeared not to be concerned over the risk of a personal lawsuit arising from their actions as a company manager or director.

Insurance professional associations in all countries should develop corporate governance codes that could help address the weaknesses.

The codes should recommend that supervisory boards of insurance companies: (1) include at least some independent members; (2) set up committees for audit, risk management, and remuneration issues and; (3) have independent members chair the committees.

Financial reporting

Good corporate governance practices suggest that:

- 1) Insurers should be required to prepare financial statements in accordance with international financial reporting standards (IFRS) on both a solo and consolidated basis.
- 2) The annual reports should be publicly available regardless of whether or not the insurer is listed or otherwise publicly traded.
- 3) The annual report should include: (a) the full financial statements, including comprehensive notes covering such issues as all related party transactions) and the auditor's opinion; (b) meaningful statements by the supervisory board and management of the performance of their responsibilities, and; (c) a statement describing the major risks of the business and how these are managed.
- 4) Additional corporate governance disclosures should include: (a) listing of the names and roles of supervisory board members and key senior managers and their major affiliations and remuneration (by bands); (b) authorities and responsibilities of the company's governing bodies, and; (c) identity of controlling or otherwise significant direct and indirect beneficial owners of the insurer.
- 5) The chairman of the audit committee and a member of the management team (either the CEO or CFO) should be required to sign the disclosure statements attesting to their accuracy and completeness.

Disclosure of financial information in many transition countries has rapidly improved over the past few years. Key financial information is generally provided. Balance sheets, profit and loss statements, reviews of operations by the chairman of the management board and external auditors' reports follow international practices. However, disclosure of ancillary information required as a matter of good corporate governance continues to lag, or is not addressed at all. Meaningful statements by the chairman of the supervisory board are also lacking.

Company financial statements should also be easy to obtain. The simplest way of making annual statements available for public use is to

stipulate that they be posted on the web. However among the EU accession countries, only Estonia requires that insurance companies post their financial statements on their corporate websites. In practice, the insurance companies of most EU accession countries maintain websites that contain the company's annual reports. Furthermore in Poland, the largest EU accession insurance market, only rudimentary summarized financial information was available on the internet.

The annual reports of insurance companies in many transition countries generally include the names of the board members for management boards and supervisory boards and the names of the senior managers reporting to the board. The names of the members of the management board and their photographs are prominently displayed whereas the members of the supervisory board are disclosed less prominently—and frequently without photographs. However, it is rare for the remuneration of directors and senior managers to be disclosed, although such disclosure is common practice in industrial and post industrial countries.

All developing and transition countries should move as quickly as possible to the adoption of IFRS for insurance company annual reports once the insurance contracts and financial instruments valuation rules are finally agreed. Regulations should specify that financial statements should be available on the internet.

In addition, over time the supervisory agencies should also require that the remuneration packages of directors and senior managers be disclosed—if only within bands.

Supervisory agency

In accordance with IAIS principles, insurance regulators need to be independently managed and governed. Supervisory agencies should follow six criteria to establish good corporate governance practices for the insurance sector:

- 1) The supervisory authority should have the legal capacity to impose corporate governance including risk management requirements on insurers. The supervisory authority should issue guidance to insurers on desirable corporate governance policies, practices and structures.
- 2) The supervisory authority should apply a “fit and proper” test to members of an insurer's supervisory board, senior managers and controlling and other significant shareholders, and should

- have the authority to remove them or freeze their voting rights as appropriate if such tests are not met.
- 3) The supervisory authority should have the power to approve external audit appointments for insurers on the basis of a transparent set of approval criteria.
 - 4) The supervisory authority should issue regulations defining related party transactions and limits on such transactions, and the regulations should include a precise definition of related parties. The regulations should require that insurers maintain reliable systems and controls for identifying, monitoring, and managing exposures and dealings with related parties. Related parties should include upstream parent entities or other controlling or significant shareholders and downstream subsidiaries and affiliates. All business dealings with related parties should be on arm's length terms and be in the interests of all shareholders, creditors and policyholders. Any significant related party transactions involving cash transfers from the insurer should be subject to prior supervisory authority approval or notification.
 - 5) The supervisory authority should operate in a transparent manner.
 - 6) The supervisory authority should use risk-based supervision methodology.

Insufficient regulation and control of related party transactions are also a common source of insurer impairment. Regulation should require that all significant transactions take place between owners and other related parties of insurance companies on "an arm's length basis", that is, on terms and conditions prevailing in a well functioning market. In four EU accession countries, all outsourcing contracts needed to be approved by the insurance supervisory agency. However related party transactions are not scrutinized in detail by many supervisory agencies. Thus services could be supplied by parent companies or other foreign entities of international insurers on terms that may not favor policyholders. Alternatively, owners of local insurance companies may provide services to their controlled insurance companies where the pricing was not determined at arms' length. Where international financial conglomerates dominate an insurance sector, the risk of non-market pricing on related party transactions expands.

A final weakness lies in the limited application of risk-based supervision (as opposed to a 'tick the box' audit based approach) in many countries. A primary responsibility of the supervisory agency is to ensure that all the insurance companies are sufficiently financially strong at all times to pay policyholder claims. Each insurance company

represents a different degree of risk. Some companies are run more conservatively and are well capitalized. Others may be riskier, perhaps as a result of selling higher risk products or operating at a lower level of capitalization. The real risk is that an insurance company will fail, that is, that it will not be able to keep the financial promises it has made. Therefore not all insurance companies ought to be investigated equally. More time needs to be spent investigating and inspecting those companies which represent a larger degree of risk to the sector.

Risk-based supervision includes a methodology by which the regulatory authority measures objectively the degree of risk of each insurance company: the supervisory agency evaluates the company's capital, systems, processes and most importantly, the application of corporate governance principals to risk management. The supervisory agency then ranks the insurance companies according to their risk profiles and designs its investigations and on-site inspections around those risks. Risk-based supervision is deemed to be far more effective in spotting problems than carrying out a general on-site inspection, say every two years. Properly done—risk-based supervision enables the supervisor to focus on the risks within the insurance industry and take remedial action at an early stage—before they become a major concern.

One key weakness for insurance supervisory agencies in a number of developing and transition countries is the conflicted role created when the state is both the supervisor of the sector and the owner of insurance companies operating in the sector. Such conflicts make it difficult for the supervisory agency to supervise the entity and enforce the legal framework in an impartial manner. Privatization or at least corporatization is a desirable step once the necessary regulatory and supervisory oversight capacity is in place.

External audit

Under international good practices external audits for insurance companies should follow five criteria:

- 1) Financial information disclosure statements should be audited by an independent external auditor at least annually.
- 2) Audits should be performed using the International Standards of Auditing (ISA) set by the International Federation of Accountants (IFAC) or equivalent national standards. All approved insurance auditors should be certified by the professional audit body to apply international audit standards and have access to

- adequate actuarial expertise. Specific attention should be paid to audit of systems as well as accounting balances.
- 3) The audit firm should be sufficiently independent of the audited entity to ensure a fair and objective audit. Insurance audit partners should be required to rotate on a periodic basis (desirably at intervals not exceeding five years), with an appropriate cool-down period for the exiting audit partner. There should be an appropriate separation between audit and non-audit services, such that the performance of non-audit services does not compromise the independence and performance of the audit. Fees paid by insurers to audit firms should be disclosed and broken down by type of service.
 - 4) Auditors should have the legal obligation to report to the supervisory board and the supervisory authority any concerns they may have in relation to a client insurer, including in respect of breaches of laws or regulations.
 - 5) Regulatory information submitted by an insurer should be audited at least annually by the external auditor where not already subject to audit.

The financial statements of all insurance companies must be subject to an annual external audit and Audit firms should be required to request the assistance of trained actuaries when auditing insurance companies. A company's annual filings with the supervisory agency should also be subject to an external audit. Fees paid to auditors should be disclosed in the annual reports and broken up into audit and non-audit services.

The external auditor should be required to report misgivings to the insurance supervisory agency.

Annex I: Insurer governance in Australia

Type of Government & Economy:	Democratic, mature and open economy
Population:	21 million
Insurance Premiums per capita:	USD 2569.9 (Swiss Re Sigma 2005)
Capital markets:	“Deep” with a well developed stock exchange including explicit governance laws relating to companies.
Insurance Accounting/Auditing Profession:	Profession is well developed & well trained. Insurance regulator approves auditors of companies.
Insurance Accounting Standards:	International Financial Reporting Standards adopted. “Fair value” adopted for insurance liabilities.
Actuarial Profession:	Required under life insurance law since 1945. Required under non life insurance law since 2002. Insurance regulator approves actuaries of companies
Corporations Law:	Very well developed with substantial compliance required by insurers, most of which are licensed under this law to sell insurance through an Australian Financial Services Licence. This license sets out what type of advice shall be provided to consumers (inter alia). Has imbedded in it training requirements for people offering advice to consumers.
Trade Practices Law:	Law exists to ensure trading is fair. It applies to insurers.

Life Insurance Law:	<p>In existence since 1945, actuarial involvement extensive. Separate from Non Life insurance law.</p> <p>Contains explicit governance requirements.</p>
Non Life Insurance Law:	<p>In existence since 1973, actuarial involvement extensive since 2007.</p> <p>Contains explicit governance requirements.</p>
Governance in Insurers:	<p>Legal requirements include:</p> <ul style="list-style-type: none"> A formal risk management strategy to be prepared and signed by the board of an insurer; The formalization of a reinsurance management strategy Auditing and actuarial reporting; Specific requirements with respect to Board size and composition with a majority of independent directors; The chairperson of the Board must be an independent director; A Board Audit Committee must be established with an independent Chair not the Chair of the board; Need for a dedicated internal audit function; Need for independence required of external auditors; The Board must have a policy on Board replacement.
Fit and Proper:	<p>An insurer must have responsible people in responsible positions including:</p> <ul style="list-style-type: none"> Directors, Managers and certain officers in specified positions. <p>Additional requirements must be met for auditors and actuaries.</p> <p>Need to report to APRA if uncomfortable with any matter.</p> <p>Insurance law has "whistle blowing" requirements.</p>

Source: APRA

Annex II: Recommendations from World Bank EU accession country financial sector governance survey

- 1) As a first priority, risk management should receive additional emphasis. Regulations should specify that insurance companies have dedicated risk management functions that monitor all types of risk that apply to such institutions. Regulations should also require that insurance companies maintain both internal audit and risk management departments and that both should have access to the company's supervisory board and to the sector's supervisory agency when they have concerns over the long-term solvency of the company.
- 2) The role of the actuary should be strengthened. Regulations should specify that all insurance companies must have appointed actuaries, either in-house or under contract with an outside firm. The actuaries should be obliged to prepare annual financial condition reports (FCRS) that are given to the company's management and supervisory boards, and the supervisory agency upon request.
- 3) Company supervisory boards should be more active. The insurance professional associations should develop corporate governance codes that recommend the establishment of supervisory board committees for audit, risk management and remuneration and that the committees be chaired by independent members.
- 4) Financial reporting should be brought to international standards as soon as possible. Regulations should require that all insurance companies prepare their financial statements in accordance with International Financial Reporting Standards (subject to any EU over-rides) and that the annual reports are posted on each company's internet website.

- 5) Audit practices should also be improved. External auditors should be required by regulation to seek the advice of qualified actuaries where they do not have sufficient in-house expertise on actuarial issues. Regulations should also require insurance companies to disclose the amount of fees paid to their external auditors, with non-audit fees separated from those for other services. Auditors should also be obliged to advise supervisory agencies where they have concerns over the long-term solvency of an insurance company.
- 6) Consumer protection should also be strengthened. The authorities should develop inexpensive and effective methods of resolving disputes between insurance companies and retail consumers.
- 7) Insurance supervisory agencies should adopt governance based risk-based supervision as soon as possible. Regulations should also give the supervisory agency oversight of the appointment of an insurance company's external auditor.
- 8) All related party transactions should be tightly regulated and transparently reported.
- 9) Governments should consider selling their remaining equity or controlling interests in insurance companies or at least corporatize them and apply the same governance and supervisory oversight rules as for private sector insurers.



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