



CZECH REPUBLIC

**PILOT ASSESSMENT OF
GOVERNANCE OF THE INSURANCE SECTOR**

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Private and Financial Sector Development Department
Europe and Central Asia Region
THE WORLD BANK

Acronyms

ČAP	Czech Association of Insurance Companies
CAS	Czech Accounting Standards
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CEA	Comité Européen des Assurances (European Insurance Committee)
CESR	Committee of European Securities Regulators
CNB	Czech National Bank
CSC	Czech Securities Commission
ČSOB	Ceskoslovenska obchodni banka, a. s.
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ČP	Česka pojišťovna, a.s.
CZK	Czech Koruna (crown)
D&O	Directors and Officers (liability insurance)
EC	European Commission
EU	European Union
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISA	International Standards of Auditing
MB	Management Board
MOF	Ministry of Finance
OECD	Organisation for Economic Cooperation and Development
OSS	Office of Insurance and Pension Fund Supervision
PSE	Prague Stock Exchange
ROSC	Report on Observance of Standards and Codes
SPV	Special Purpose Vehicle
US	United States
UK	United Kingdom

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Pilot Assessment of Governance of the Insurance Sector

Executive Summary

In essence corporate governance of insurers concerns the management of risk. Risk management requires that: (1) sufficient capital be retained by the business given the insurer's risks and (2) the governance structure takes into account the rights and interests of all stakeholders within the context of the way a particular country's institutions and financial infrastructure are organized.

Key elements of insurance governance include the regulatory approach, the strength and approach of the supervisor, the role of the professions (actuaries and auditors), the legal structures and financing of institutions and the roles of boards and managements. A strong system would be characterized by: (1) appropriate risk management and risk-based capital requirements, (2) effective supervisory boards, (3) appropriate regulation including accounting standards, (4) corporate structures which inhibit the easy and non-transparent transfer of assets, (5) a risk-based supervisory approach, and (6) strong protection of policyholders, creditors and minorities in the event of corporate stress or insolvency.

At the time of the first World Bank mission in February 2005, the Czech insurance sector fell well short of this ideal—despite its good earnings record and substantial improvement in recent years. Some of the issues had been resolved by the time of the second mission eight months later, but many still remained outstanding. While supervisory boards of Czech insurance companies generally follow the requirements set by law—and many go beyond the minimum requirements—not all companies had effective supervisory boards. Indeed audit committees were the exception rather than the rule. There was (and still is) no mandatory separation of life and non-life business within established insurers.¹ Some auditors accepted actuarial valuations of liabilities without review (still the case). Not all companies were using modern approaches to enterprise risk management (ERM). The supervisor employed an audit-based approach. This should change with the consolidation of supervisors in 2006.

The provisions of two key EU Directives had not been fully transposed into national law (since partially rectified). In addition, the OSS as the coordinating supervisor under the Conglomerates Directive did not appear to have the resources to carry out full supplementary supervision of a complex cross-country group (although this is also expected to change when the various financial sector supervisors are consolidated). The bankruptcy system also remained inadequate to guarantee fair and equitable financial sector resolution (although as of February 2006 revised insolvency legislation was under discussion in the Czech Parliament).^{2 3}

¹ The EU Insurance Directives have introduced permanent grandfathering, allowing existing companies to avoid establishing separate life and non-life companies as long as the assets, income and expenditures are clearly separated between the two types of business.

² See *Czech Business Weekly*, October 3-9, 2005, page 25

³ Note that systems which have suffered unexpected shocks after long periods of stability often see strong and possibly excessive regulation being subsequently introduced under political pressure. Examples include Australia, the UK and Canada. The assessment recommends that action be taken to avoid such shocks—and future over-regulation of the sector.

Introduction

In recent years the World Bank has reviewed the corporate governance of banks and insurance sectors in many countries as part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP): governance has consistently proved to be one of the weakest elements identified in the financial sector. Looking to take a more detailed and structured approach, the World Bank recently developed a template containing a set of best practice benchmarks to assess corporate governance of banks. This template was subsequently adapted to the insurance sector.

This insurance governance assessment is one of a series of pilot financial sector governance assessments prepared by the World Bank at the request of the Czech Government, which has taken the lead in supporting this work. The other assessments include those on the banking, collective investment fund and private pension fund sectors. This assessment is the first effort to employ the insurance template. The template has been further refined based on the experience with the Czech assessment and transmitted to the International Association of Insurance Supervisors (IAIS), which is planning to examine this topic. A copy is available on the World Bank's Financial Sector web site.⁴

This assessment of the governance of the Czech insurance sector has three objectives: (1) develop a set of best practice benchmarks for assessing the governance of insurance sectors in the Europe and Central Asia Region and elsewhere, (2) conduct a trial assessment of the Czech insurance governance framework against these benchmarks, and (3) provide recommendations on ways of further improving the corporate governance of the Czech insurance sector. The benchmarks and the assessment are found in Annex I and a list of recommendations is presented in Annex II. As this is a pilot assessment, the final report should be seen as no more than a "work-in-progress." Nevertheless, it is expected that it will play a useful role in contributing to guidelines for strong corporate governance of insurers in both developed and emerging markets. It could also lay the basis for further governance-based reforms of the Czech insurance sector and provide a baseline assessment for measurement of the reforms.

Implementation of some of the report's recommendations may require revision to legislation, including changes to the Commercial Code and the Act on Insurance. Other recommendations may involve reallocation of budget resources to improve the quality of supervision. The report presents the view of an outside institution and leaves it to the Czech authorities to decide if (and how) the recommendations should be implemented.

The report is based on two World Bank missions to the Czech Republic. The mission of January 27-February 3, 2005 was led by Marie-Renée Bakker (then Finance & Private Sector Program Leader New EU Member States/Lead Financial Sector Specialist, ECSPF) and comprised Sue Rutledge (Regional Corporate Governance Coordinator/Senior Private Sector Development Specialist, ECSPF) and Rodney Lester (Head of the Insurance and Contractual Savings Group and Senior Advisor, OPD). The second mission was conducted October 3-7, 2005 and consisted of Sue Rutledge and Rodney Lester, and included a half-day workshop hosted by the Ministry of Finance on the draft assessment. Representatives of the insurance sector and journalists participated in the workshop and provided valuable feedback on the draft report, which was subsequently revised. Valuable assistance was also provided by Zdenek Kudrna of the Charles University in Prague in completing a preparatory questionnaire.

The missions met with officials from the Ministry of Finance (MOF), its Office of the State Supervision in Insurance and Pension Fund (MOF/OSS), the Czech National Bank (CNB), the Czech Securities Commission (CSC), the Prague Stock Exchange (PSE), the Czech Insurers Association (ČAP), the

⁴ A copy can be downloaded at www.worldbank.org/capitalmarkets

Czech Association of Registered Investment Intermediaries, and numerous insurance companies, law firms and audit firms. The Team also met several large insurance companies (Česka pojišťovna, Kooperativa, pojišťovna, and Allianz pojišťovna) and two smaller companies (UNIQA pojišťovna and Aviva životní pojišťovna). The World Bank would like to express its gratitude for the efforts of all parties involved to facilitate the preparation of the assessment.

Methodology

The report draws on earlier financial sector studies prepared by the World Bank for the Czech Republic, including a Capital Market Review in 1999, a Financial Sector Assessment Program (FSAP) Review in 2001, a Corporate Governance Report on Observance of Standards and Codes (ROSC) in 2002, an Accounting and Auditing ROSC in 2003, a pilot Bank Exit Study in 2004 and also in 2004 pilot Governance Assessments of the Bank and Collective Investment Fund Sectors.

The corporate governance benchmarks for insurance companies have been drawn from a wide range of materials in addition to the bank governance template. These include guidance prepared by the IAIS, the various OECD Corporate Governance Principles and various national codes on corporate governance. The April 2005 OECD guidelines for insurance governance provided valuable input, as did the European Commission's Action Plan to modernize company law and enhance corporate governance in the European Union (EU). In addition, the Commission's February 2005 Recommendations on strengthening the role of non-executive or supervisory directors (2005/162/EC) provide useful suggestions on the role of supervisory boards, the independence of non-executive board members, the structure of board committees and minimum training requirements for board members.⁵

One caveat remains in order. The benchmarks are in draft form and should therefore be regarded as no more than a framework for assessing corporate governance in insurance companies and similar financial institutions. It is recognised that there are different approaches to achieving sound corporate governance although some elements, such as adequate internal controls apply to all financial institutions. It should also be noted that the benchmarks have some overlap with the OECD principles for corporate governance. In addition the legal and regulatory framework and business environment in the Czech Republic influences the extent of compliance with the proposed benchmarks. Rather than specifying rigid standards, the benchmarks are intended as a general guide highlighting key areas of importance for governance of insurance companies.

The Role of Corporate Governance in the Insurance Sector

Sound corporate governance ensures that corporate insiders do not use their privileged position to exploit other stakeholders, notably small minority shareholders, creditors such as lenders, 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, La Porta et al 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.”⁶

⁵ A copy can be downloaded at http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf

⁶ La Porta, Rafael et al., *Investor Protection: Origins, Consequences, Reform*, World Bank, 1999

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**. The challenge is to set regulation that has sufficient scope but at the same time does not become an excessive cost for business. It is also important that the courts and regulatory/supervising processes cannot be captured by insiders for their own benefit.

In the early stages of development, the insurance sector is often seen as a commercial enterprise. The primary insured parties are industrial firms and entrepreneurs. At this stage, relatively light regulation 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 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). 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 Czech Republic is currently at this stage.

All insurance companies--but particularly life insurers--are obliged to meet long-term obligations. Policy-holders expect that when payments fall due, sometimes 40 years or more after the policy was purchased, the insurance company will have the financial resources to fulfil its obligations. The establishment of adequate technical provisions and the accumulation of sufficient reserves is thus a critical element of sound insurance financial management. 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 dependent on the ability and inclination of management (and the oversight board) to take conservative and prudent risks and have sound capital management. In addition policy-holders depend on the willingness and ability of key shareholders to contribute additional capital when needed—and the supervisors to ensure that all key shareholders have such willingness and capacity.

Strong governance in the insurance sector requires two lines of defence. The first line of defence consists of the internal organs of the company—its management, risk management system, the company's actuary and the company's supervisory board that should have oversight of them all. More than most financial activities, life insurance requires that management and directors of insurance companies find a trade-off among the rights of various constituencies and stakeholders. In a number of countries, the law makes it clear that life insurance company directors have an overriding responsibility to policy-holders. External measures provide the second line of defence. The external measures cover both the supervising authority that oversees the insurance companies and market mechanisms that monitor and influence the sector. Both lines of defence are needed to ensure a high level of transparency and accountability in the sector. Furthermore the burden on the supervisory authority is reduced if the companies' internal governance arrangements are strong, or where the market provides an effective form of discipline.

Corporate governance should therefore be an important part of the formal supervisory framework for insurance sector. The IAIS Core Principles point to the specific governance issues which apply to insurance enterprises:

“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. These matters are described in the criteria below. 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.”⁷

Key criteria relevant to the insurance sector are as follows:

- The supervisory authority requires and verifies that the insurer complies with applicable corporate governance principles.
 - 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 balances⁸.
 - 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.
 - The supervisory board communicates with the supervisory authority as required and meets with the supervisory authority when requested.
 - 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.
 - 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 Czech Commercial Code and enhancements in the Insurance Law make it clear that it is the supervisory board which is intended to fill this role. Recent events in countries with similar Civil Code legal systems, Germany and Austria in particular⁹, support this view.

Effective regulation of corporate governance involves finding the right balance. Too many rules will discourage the entrepreneurial spirit that drives a dynamic corporate sector and can result in an unhealthy compliance burden. Too few rules open the door to abuse and corporate fraud. Each country must find the balance appropriate to the level of financial sector development, the local business culture and the agreed objectives for further development.

This assessment does not propose more regulation. Rather it proposes better regulation focused on unleashing a healthy competitive and innovative spirit in the insurance sector. The assessment suggests measures that would help to prevent corporate governance abuses in the Czech insurance sector, while minimizing the regulatory burden. In particular the assessment employs a market-based approach to

⁷ Paragraph 9.3. IAIS Core Principles, October 2003

⁸ The EU has tried to overcome the problem of applying this to a bicameral board structure by reference to a functional approach. In this case this would mean that the supervisory board assumes ultimate responsibility and monitors that appropriate audit functions, actuarial functions, strong internal controls and applicable checks and balances are established.

⁹ See for example, 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.

supervision and governance, as epitomized by the Basel II¹⁰ approach to bank risk management and the insurance Solvency II¹¹ model that is currently being developed. Such a market-based approach sees minimal involvement of supervisors in product approvals and pricing. Instead using a market-based system, supervisors should focus on ensuring that insurance companies have adequate economic capital and internal controls, company balance sheets have sufficient transparency, and enlightened market conduct rules are in place and functioning well.

Legal Foundations for Czech Insurance Sector Governance

In the Czech Republic, the Act No. 363/1999 Coll. on Insurance as amended (the Insurance Act) regulates the legal form of insurance companies: an insurer may be a joint-stock company or a cooperative. All major insurers are joint stock companies.

Steps have been taken to harmonize the insurance legal framework with the EU standards prior to the Czech Republic's accession in May 2004. Act No. 39/2004 Coll. amended the Insurance Act by transposing provisions of the "third-generation" EC directives relating to life and non-life insurances. Among other provisions the Act sets forth the manner in which an insurance company from another Member State or a third country can do business in the Czech Republic (freedom of establishment, freedom to provide services) and imposes upon insurance companies the obligation to have an internal control system.

The Act does away with the practice of having insurance terms and conditions approved by the supervising authority, but insurance companies must submit them to the Ministry, upon a written request, for a legal compliance check. The amendment also adds to, expands, and changes the Act's provisions relating to insurance accounting rules.

A new Act on Insurance Contracts became effective on January 1st, 2005. The Act imposes new disclosure obligations on insurers. Another new piece of consumer legislation is the Act on Insurance Intermediaries and Independent Loss Adjusters. This aligns the Czech legal framework with EU Directives aimed to establish a "European Passport" for insurance intermediaries by defining conditions for conduct of this activity including ensuring a degree of consumer protection.

Another component of the "package" of insurance laws is Act No. 47/2004 Coll. amending Act No. 168/1999 Coll. on motor third party liability insurance and amending certain related acts (taxes, misdemeanours, Civil Code procedures). The Act implements the Fourth motor insurance Directive, which is aimed at ensuring a higher degree of protection of victims of motor accidents within the EU.

Other laws and regulations, which were a part of the overhaul of the insurance industry's legal framework include:

- Decree No. 309/2004 Coll. implementing the Motor Third Party Liability Insurance Act; and
- Decree No. 502/2002 Coll. implementing certain provisions of Act No. 563/1991 Coll. on accounting of insurance companies
- Decree No.303/2004 Coll. implementing some provisions of the Insurance Act.

The last major piece of legislation, involving financial conglomerates, was passed shortly before the October 2005 workshop, and is due to become effective in early 2006. The Act on Financial Conglomerates (Act No. 377/2005 Coll.) introduced adequate risk management procedures within, and supplementary supervision over conglomerates. The Czech authorities consider this, together with the

¹⁰ Further information can be found in www.bis.org

¹¹ Further information can be found in www.iais.org

adoption of the Wind Up Directive¹², to be the final steps in the overhaul of the insurance industry's legal framework. Due to the recent adoption of the legislation, the Bank Team was not able to assess the implementation of the Insurance Wind Up Directive (which was introduced as part of the Conglomerates Act).

Some additional indirect changes will be introduced by the amendment of the Bankruptcy and Composition Act, which is yet to become law and is proving to be contentious. The amendment will implement the EU directives on the winding up of financial institutions. Further, changes are possible when a completely new Bankruptcy Act is drafted. This will hopefully deal with abuses of receivership provisions which have occurred in the past and which could be relevant to the insurance sector.

The Czech Insurance Association, an advocacy group accounting for well over 99 percent of the market premium income in the Czech Republic, is an active member of the CEA (the umbrella association of the Member States' insurance associations), which has called for a moratorium on new rules and a cost-benefit analysis of the existing regulatory framework (see ČAP 2003: 11-12). However for the period of 2006-10, the EU has adopted a Financial Services Policy paper, which includes extensive revision of financial sector legislation including laws on insurance. The Czech Insurance Association supports the reform measures described in the Policy paper. In addition, the Association has been active in introducing technical specifications on underwriting methodology, as recommended by CEA.

Czech insurance companies are also subject to the following legislation:

- The *Commercial Code* which is the default law mediating the structure of commercial entities and their governance arrangements;
- The *Civil Code* which is the default law under the Insurance Contracts Act; and
- The *Decree implementing the Act on Accounting for Insurance Companies* (No. 502/2002), deriving from the *Law on Accounting*.

Overview of the Czech Insurance Sector

The standard penetration and density measures of insurance sector development (premium income divided by GDP and premium per capita respectively) have shown acceleration as would be expected at this point of the Czech Republic's economic development.

Table 1 - Insurance Penetration & Density Development

	1993		1996		1999		2003		2004	
	CR	Germany	CR	Germany	CR	Germany	CR	Germany	CR	Germany
Penetration %	2.3	6.3	2.7	6.7	3.4	6.7	4.5	7.0	4.2	7.0
Density \$US	97	1475	147	1902	176	1718	364	2051	431	2287

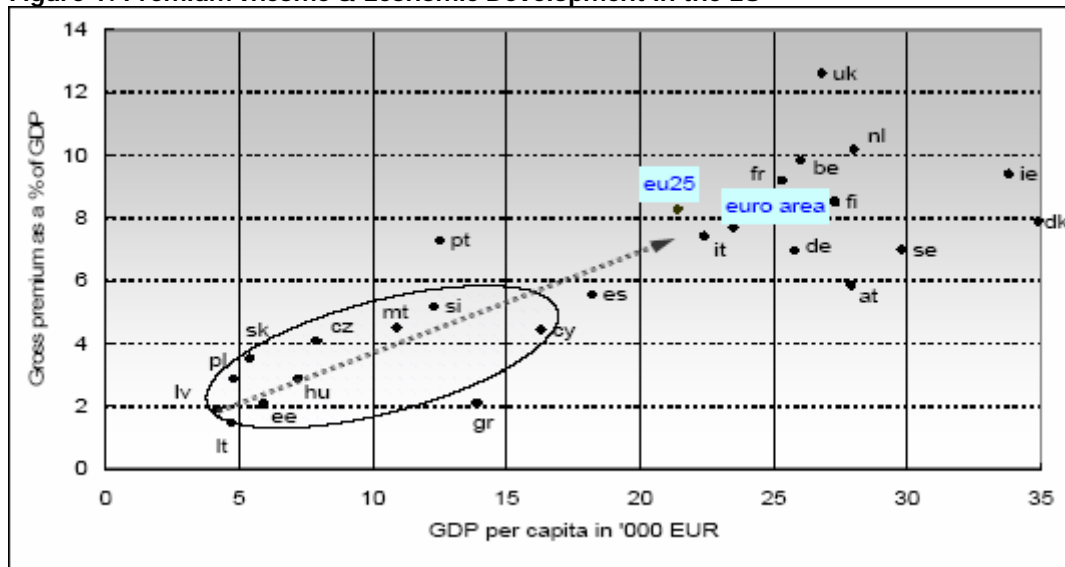
Source: SIGMA Annual Surveys, OECD

Consistent rapid growth in the sector can now be expected for an extended period. This should be based largely on the need for long-term savings, and life insurance and pensions¹³ in particular. This trend is borne out by an analysis of the development of the sector in other countries of the European Union. As noted earlier, this will place new and complex pressures on the supervisor and raise the importance of governance in the sector.

¹² Act No. 377/2005 Coll. does not specify which of the two alternative methods of earmarking life insurance assets in a composite will apply in the Czech Republic (Article 10, 2001/17/EC)

¹³ As structured at the time of the workshop, pension funds had some of the characteristics of pension insurers.

Figure 1: Premium Income & Economic Development in the EU



Source: European Commission, *Financial Integration Monitor 2005, Background document*

While the insurance industry is still a minority player in the financial sector it is already becoming a significant capital market player, as seen in recent insurance/ banking comparatives. Unlike the banking sector, the insurance sector has had relatively steady growth and has not suffered any major crises or collapse in the last 15 years since the beginning of the Czech Republic's transition to a market economy.

Table 2 - Insurance Liabilities/Bank Deposits Ratio

Million CZK	1997	2000	2004
Client deposits	1,112,050	1,408,063	1,731,850
Liabilities to policy-holders	110,645	148,062	239,669
Ratio	9.95%	11.09%	13.84%

Source: ČAP (www.cap.cz), Czech National Bank (www.cnb.cz)

Note: Liabilities to policy-holders are proxied as total liabilities minus shareholders equity, retail deposits as total liabilities to clients.

The insurance sector accounts for a significant part of the bond market, although this is reducing as alternative uses are found for funds:

Table 3 - Fixed Income Securities

Million CZK	2000	2001	2002	2003	2004
Market capitalization of bonds issued in Czech Republic	280,075	319,399	372,487	505,535	577,036
Fixed income securities held by insurance companies	93,614	109,419	133,537	145,299	154,900
Ratio (%)	33.4	34.3	35.9	28.7	26.8

Source: Prague Stock Exchange (www.pse.cz), ČAP (www.cap.cz)

Note: As the total value of the fixed income securities issued in the Czech Republic was not available, the market capitalization of bonds has been used as a proxy.

The Czech insurance market is highly concentrated, as is common in the post-transition economies of central Europe. The five largest insurance companies write over 75 percent of premiums, with the largest insurer accounting for 37 percent. Four out of the five largest insurance companies are controlled by foreign strategic owners, whose primary operations are based in the European Union.¹⁴

The largest insurer, Česká pojišťovna,¹⁵ is owned by the Czech financial conglomerate PPF Group and has a Dutch registered parent. Under the July 29, 2005 Identification of Financial Conglomerates (as required under Article 3 of Directive 2002/87/EC Conglomerates Directive),¹⁶ ČP and as well as the PPF Group and Petr Kellner (the controlling shareholder of the PPF Group) were identified as potential financial conglomerates falling under the supervision within Czech Ministry of Finance (OSS).

None of the equities of Czech insurance companies is publicly traded on the Prague Stock Exchange. ČP is 100% owned by its parent, but issues listed corporate bonds. Corporate bonds need to be listed to be admitted investments for various institutional investors, including pension funds.

Table 4 - Major Czech Insurance Companies

	Direct Shareholding Structure	Ultimate Shareholding Structure	2004 Premiums written (mil. CZK)	Market Share %
Česka pojišťovna (ČP) a.s.	100 % PPF Group N.V. (Netherlands)	See footnote	40,970	36.7
Kooperativa, pojišťovna, a. s.	84.6 % Wiener Städtische Allgemeine Versicherung AG. (Austria) 12.3 % Svaz českých a moravských výrobních družstev (Czech Republic) 3.1 % VLTAVA majetkoprávní a podílová spol. s r.o. (Czech Republic)	As per direct shareholding structure	24,167	21.7
Allianz pojišťovna, a. s.,	100 % Allianz AG (Germany)		8,951	8.0
ČSOB Pojišťovna. a.s.	75 % KBC Verzekeringen NV (Belgium) 25 % ČSOB (Czech Republic)		6,057	5.4
Nationale-Nederlanden Life insurance branch	Branch of ING	ING Verzekeringen N.V. (Netherlands)	5,325	4.8
Generali Pojišťovna a.s.	100 % Generali Holding Vienna AG (Austria)	Assicurazioni Generali (Italy)	5,021	4.5
Pojišťovna České spořitelny. a.s.	55.2 % Česká spořitelna. a.s. (Czech Republic) 44.8 % Sparkassen Versicherung AG (Austria)	Erste Bank and Sparkassen Versicherung konzern (Austria)	3,894	3.5
Others			17,154	15.4
Total			111,539	100

Source: ČAP and company websites

The Insurance Act of April 1, 2000 specifies that licensed insurance companies are permitted to offer either life or non-life insurance products, but not both. Composites (insurance companies that hold licenses for both life and non-life insurance products) are required to separate the two businesses by

¹⁴ The Czech Insurers Association has advised that the ultimate owners of ČP are Czech natural persons.

¹⁵ Market analysts still perceive Česká pojišťovna (ČP), the former monopoly insurer, as having significant influence. The CEO of ČP is currently the President of the Czech Insurance Association (ČAP).

¹⁶ See

http://europa.eu.int/comm/internal_market/financial-conglomerates/docs/20050729_conglomerates_bycountry.pdf

April 1, 2010. An amendment approved in December 2003--after intense industry pressure--allows composite insurers to retain their license on condition of separate management of the two activities in line with the exemption permitted under the EU Insurance Directives.

Table 5 - Current Types of Insurance Companies

	1993	1996	1999	2003	2004
Total	20	35	42	42	40
Of which: life	5	2	3	3	3
non-life	7	14	21	23	21
composite	8	19	18	16	16

Source: ČAP 2004

Sections 21a and 21b of the Act define the types of assets which can be held by insurance companies to support technical provisions. Section 4 of the Decree No. 303/2004 Coll. of the Ministry of Finance defines asset class limits as in the following table.

Table 6 - Permitted Types of Assets and Limits on Technical Provisions

Type of Asset	Maximum Proportion on Technical Provisions
Bonds, issued by Member State or its central bank, and bonds for which the guarantee has been assumed by Member State	75%
Bonds issued by banks and similar credit institutions of the Member States	50% (one bank max 20%)
Publicly negotiable corporate bonds	20% (one corporation max 5%)
Treasury bills	75%
Publicly tradable municipal bonds	20% (one municipality max 5%)
Loans, credits and other receivables secured by a bank guarantee	10% (one borrower max 5%)
Bills of exchange secured by a bank guarantee (aval)	10%
Real estate in the territory of the Member States	20% (one estate max 10%)
Registered mortgage bonds	50% (one issuer max 20%)
Publicly tradable shares	10% (one issuer max 5%)
Stocks and bonds issued by unit of collective investment	20% (one issuer max 5%)
Deposits and deposit certificates with banks authorized to operate as a bank in the territory of the Member States	50% (one bank max 20%)
Insured objects and works of art appraised by at least two appraisers	5%
Bonds of EIB, ECB, EBRD, IBRD	75%
Foreign securities traded on the regulated market of the OECD member states	10% (one issuer max 5%)
Loans to insured persons with a life insurance contract	5%
Hedging derivatives; these hedging instruments may hedge only items specified above (excerpt of loans to insured persons)	5%
Reinsurance receivables; these receivables may be used only after due deduction of all commitments to the reinsurance undertakings	50%

Source: Ministry of Finance

Section 13(9) of the Act requires that when placing financial assets for technical provisions, the insurance company is obliged to follow four principles:

- The individual items of financial placements would provide a guarantee of return of invested resources (*principle of safety*),
- The individual items of financial placements would ensure a yield from their possession or a profit from their sale (*principle of profitability*),
- Depending on the nature of the insurance or reinsurance activity carried on, a part of the financial placements would be promptly available for the payment of claims within the period stipulated by a special provision (*principle of liquidity*),
- The individual items of financial placements would be diversified among a larger number of legal persons, none of which is in a relationship of a controlled and controlling person or persons acting in conformity according to a special legal provision (*principle of diversification*).

In line with the relevant EU Directives, there are no limits stipulated for the investment of assets supporting capital that does not form technical provisions of the insurance company. However at the time of making the investment, the insurance company has to make clear whether it is investing its own capital or technical reserves. Ex-post manipulations between the two are not permitted.

Key Findings and Recommendations

While there are a wide range of recommendations emerging from this assessment (see List of Recommendations in Annex II) three issues stand out:

- The potential for related party transactions and cash transfers to exceed prudent levels, as measured by economic capital and for such transactions to not be fully disclosed;¹⁷
- The virtual non-existent role of supervisory boards and audit committees in the risk management and overview of internal controls of many insurance companies; and
- The absence of effective separation of life and non-life businesses combined with a bankruptcy and court system which has in the past lent itself to misallocation of earmarked assets.

Related-Party Transactions and Financial Transparency

The emergence of large financial and mixed conglomerates in international finance has created an additional layer of governance concern. By their nature, conglomerates seek to take advantage of the synergies and efficiencies inherent in a group corporate structure. Their presence across several jurisdictions and several sectors generates a powerful corporate engine that, in a competitive environment, can generate lowered prices and a higher quality of services for consumers. However, the synergies also provide the opportunity for corporate governance abuses through the transfer of cash (see Annex III-Confederation Life Case Study), goods and services among the companies in the conglomerate. In both industrial and developing markets, a general concern is that minority shareholders may be disadvantaged in companies that are parts of conglomerates or business groups. Abuses could be made through intra-group transfers that are made at above-market (or below-market) prices in order to avoid taxes or reduce profits available for distribution to minority shareholders. Similar issues apply for other stakeholders including policyholders.

¹⁷ In this regard economic capital can be seen to incorporate hidden reserves in the asset and liability valuation methodologies; however these are not seen as being significant in the Czech Republic. It can be expected that Solvency II will in many cases lead to increased statutory capital requirements in life insurance.

Czech insurance companies without listed securities continue to employ Czech Accounting Standards (CAS) set by the MOF. CAS has the advantage of familiarity, thus assisting local companies in fulfilling their financial reporting obligations. However, CAS also has the disadvantage that non-Czech investors may not be fully aware of the implications of the different standards (for example the differing treatment of consolidated accounts, establishment expenses, leases etc). The EU requires that International Financial Reporting Standards (IFRS) be used for all consolidated accounts including companies with listed securities, starting in 2005: thus IFRS applies to the ČP group as it issues listed securities.¹⁸ Both the leading insurer and a number of other large international insurers are required to prepare two sets of books, i.e. one under IFRS and another under CAS. An effective approach would be to require that all public interest entities, including financial institutions, adopt IFRS. Such a move would reduce the cost of accounting and audit in the industry, (although CAS statements may still be required for tax reporting). In addition the average quality of audit would improve.

Another weakness is that primary responsibility for the accuracy of the key accounts and ratios appears to lie with each company's responsible actuary with no legally required external review¹⁹. The regulatory returns for Czech insurance companies are generally not audited by the external auditors. The actuaries are not subject to peer review. In addition the supervisors do not receive sufficient information to independently confirm the accuracy of the technical provisions and solvency ratios. Based on a number of failures and scandals in other jurisdictions in recent years, international practice now requires peer review of actuarial work. This is particularly important given the shortage of actuaries in the Czech Republic. Such a formal review process is generally considered best practice and has been introduced in a number of European countries and elsewhere. Countries requiring peer review include the UK and Canada. Other countries are considering it, including India and Australia. Such additional audit services should not be overly expensive, if linked with the accounts audit.

Disclosure of derivative financial contracts is an important issue for all contemporary financial institutions. Section 4 (2) of the Decree No. 303/2004 Coll. of the Ministry of Finance specifies that derivative instruments can be used only if the underlying contracts are held by the insurer and only if they contribute to a reduction of investment risk or facilitate efficient portfolio management (although this latter term is not defined). Derivative contracts may not exceed 5 per cent of the total technical provisions but the Decree does not specify the valuation methodology for derivative instruments.²⁰ The supervisory skills required to oversee these activities need to be relatively advanced and there are numerous examples, even in advanced industrial countries, of institutional investors and banks failing to catch developing exposures before they did substantial damage. Ultimately the best defence is the quality of the insurers' internal controls and risk management.

Investment in subsidiaries is also an important issue. Czech law does not establish guidelines limiting what types of subsidiaries an insurance company may set up or invest in. This is surprising given the Czech experience with "tunnelling" (illegal asset stripping) of banks and credit unions, when various forms of subsidiaries and special purpose vehicles (SPVs) were misused. However, when asked, stakeholders did not perceive this as a problem. The rules on consolidation have been tightened and supplementary supervision of financial groups of which insurance companies are a part has been introduced (see Section 26b, 26c and 26d of the Act), and will be strengthened further by the new law on financial conglomerates.

¹⁸ Note that Czech law requires that publicly-traded companies prepare a special report on related-party transactions. The report—including intragroup pricing of transactions—is verified by the company's external auditor. The report is prepared in addition to the IFRS statements.

¹⁹ A number of small insurers are still audited by one man firms which do not have the capacity to overview the key actuarially determined balances. A number of the largest insurers use one big 4 firm with in house actuarial capacity. However in a dispute between the actuary and the auditor the actuary would probably prevail under current circumstances. The auditor should in fact have ultimate responsibility to sign off on all accounts.

²⁰ However the one major insurer Česká pojišťovna (ČP) which is active in derivative markets does disclose valuations in its published annual report.

The EU Directives, and particularly 2002/87/EC on supplementary supervision of financial institutions in a financial conglomerate, provide clear direction on the supervision required for financial conglomerates. The EU Directive requires that a co-ordinating financial regulator be identified for financial groups and that the co-coordinator should report on intra-group transactions and risk concentration. The Directive also notes that the competent authorities should take into account the specific group and risk management structure of the conglomerate and define appropriate thresholds based on regulatory own funds and/or technical provisions. In particular, the authorities should monitor: (1) the possible risk of contagion within the financial conglomerate, (2) the risk of conflict of interests, (3) the risk of circumvention of sectoral rules (also called regulatory arbitrage), and (4) the level of risk.

The Act on Financial Conglomerates dated August 2005 provides a solid basis for such supervision. In particular, the Act requires that intra-group transactions for financial conglomerates be conducted in such way that they: (1) will not damage the interests of policy-holders, investors or other clients, (2) will not bind regulated entities to transactions for which no adequate counter-value is provided, and (3) are concluded at the usual terms and conditions. The Act also specifies the co-ordinating supervisory authority and requires limits on risk concentration and intra-group transactions for financial conglomerates. Furthermore the OSS is the designated supervisor under a recent EC announcement listing ČP as a financial conglomerate.

The Czech insurance law also mentions supplementary supervision and some summary disclosure of related-party transactions is also required under the provisions of the Commercial Code, although until now it could effectively only be applied at the level of the insurer or accessible subsidiary and parent companies. At the time of the mission, the Bank Team saw no evidence of active supervision of non-insurance subsidiaries, associated non-insurer firms or non-resident holding companies—suggesting the need for the OSS to further develop its supervisory capacity over the non-insurance activities and holding companies of Czech insurance companies.

Full implementation of the “Post-BCCI Directive” 95/26/EC would also be helpful. Among other things this Directive requires that competent authorities should not authorize (or continue the authorization of) financial undertakings where close links between the financial institution and natural or legal persons would prevent the authority from effectively exercising its supervising functions. This requirement is also mentioned in the prologue to the EU Life Insurance Directive and is mentioned in the Czech insurance law. It is critical that the supervisory authorities are able to effectively supervise the activities of all financial institutions in the Czech Republic in an integrated fashion, so that the full picture is available. Complex legal structures that obfuscate the true ownership and control structures of companies may prevent the authorities from fully fulfilling their supervisory responsibilities, including monitoring related-party transactions. The financial regulators should have sufficient tools at hand to minimize the risk that large related-party transactions might undermine the solvency of regulated entities. The issue applies to both Czech and foreign-owned insurance companies, since even in large international groups using full IFRS, it may be difficult to accurately trace intra-group transactions.

Another issue involves captive insurers, which in other countries have been used for tax avoidance, capital transfer and money laundering. Ideally the US rules on captives should be employed for determining the legitimacy of an insurance placement. As concerns the criteria for acceptance of reinsurers for solvency purposes, the OECD 1998 Recommendation on the Assessment of Reinsurance Companies could be usefully applied.

Role of the Supervisory Board

The corporate governance scandals of Ahold and Parmalat in Europe (and Enron and WorldCom and others in the United States) have encouraged advocates of corporate governance reform to review the

mechanisms for oversight of company managers. Traditionally the corporate governance advocates in Anglo-American systems and those in continental systems have taken different approaches to corporate governance reform. While major differences continue to exist, both are paying attention to increasing the effectiveness of the supervisory or oversight board. In the unicameral system of the English speaking world the key issue is to increase the representation and effectiveness of those board members who are independent of company management. In Europe, the dual-tiered board structure has already established an oversight board (or “supervisory board”) that theoretically excludes members of the executive management. The key issue then is to increase the authority and responsibilities of the supervisory board.

The Czech Commercial Code establishes a board of directors (in Czech "*predstavenstvo*”), which is the statutory organ for a joint stock company. The board of directors decides all company matters, unless they fall within the powers of the general meeting or supervisory board under the Code or the company's statutes. Thus under the Czech law, the board of directors is effectively a management board. The supervisory board (in Czech "*dozorci rada*") monitors how the board of directors exercises its range of powers and how the business activity of the company is conducted. However under the Commercial Code, the supervisory board of a joint stock company is primarily an inspection organ. The assessment therefore assumes that the effective board of directors is essentially the management board, consisting of the company's executive management, and having responsibility for day-to-day matters. There appears to be no explicit fiduciary responsibility to insurance policyholders specified in any Czech Law, except to the extent that a claim has become manifest and a creditor status created²¹.

The supervisory board has also filled a role as the employees' means of representing their interests. Given the current importance attached to this model in the Czech Republic it is probably unrealistic to effect fundamental change (although employees are increasingly being removed from boards elsewhere in Europe). A better alternative may be to apply the pension funds approach, wherein employees may not sit on the board themselves but in practice have nominated representatives on the supervisory board.

The assessment recommends that, to improve corporate governance in the insurance sector, the role of the supervisory board should be greatly strengthened and at a minimum, should include authority and responsibility for over-viewing and approving the company's strategic direction and the systems of internal controls and risk management. Insurance supervisory boards should also review the report of the responsible actuary, as part of its discussions with the external auditor.

One key way of increasing the effectiveness of supervisory boards is through the establishment of committees within the boards. Establishment of an audit committee has become a standard minimum requirement for US-listed companies, following the provisions of the Sarbanes-Oxley²² legislation. It is also a reportable item under the German Corporate Governance Code²³. Best practice thus suggests that the supervisory boards of all insurance companies in a market as developed as that in the Czech Republic should also include audit committees²⁴. One leading Czech insurer and several small companies were reported as having active audit committees. However all insurance companies (and other financial institutions) should be required to have audit committees on the supervisory boards. Other committees may also be useful, including a remuneration committee to consider levels of remuneration for members

²¹ The only reference to any type of fiduciary responsibility reads as follows: Members of the board of directors, who are responsible to the company for damage, shall be jointly and severally liable (as sureties) if the board member concerned failed to settle such damage (i.e. damages) and creditors cannot satisfy their claims (receivables) from the company's property due to its insolvency or because the company stopped making payments. The extent of such liability shall be limited by the extent of the duty of the board's members to provide compensation for damage. Liability of the board's member is discharged when he settles the damage caused (Section 194(6), Commercial Code). The status of policyholders before a formal claim arises is not clear under the law.

²² Further information can be found in www.sox-act.org

²³ A proposed amendment to the German Code recommends that the chairman of the audit committee should have special knowledge of accounting and internal control methods.

²⁴ The IAIS governance ICP covers committees as a supplementary requirement.

of both boards, and a nomination committee to review the performance of supervisory board members and identify new members for consideration by the shareholders' meeting.

While the European Commission is still developing recommendations on supervisory boards, it may be helpful to review the February 2005 Recommendation on Non-Executive or Supervisory Directors.²⁵ The Recommendation suggests that the non-executive or supervising directors should have a key role in overseeing executive or managing directors and in dealing with situations involving conflicts of interest. The Recommendation further defines independence of the supervising directors as "the absence of close ties with management, controlling shareholders, and the company itself." In small tightly-knit economic markets, it may be difficult to identify sufficient directors with no ties with a major corporation. However the focus on independence of judgment and freedom from material conflicts of interest is a key issue in establishing an effective oversight function.

Separation of Life and Non-Life Business

One of the key issues for institutions involving pooled funds is the segregation of assets. In the investment fund sector, for example, the assets of investors in mutual funds need to be clearly and legally separated from those of the broker or broker-dealer. Similarly in the insurance sector, the assets funding the liabilities of long-term life insurance policy-holders should be separated, both physically and legally, from the assets available to pay the claims of short term insurance business, such as property and casualty insurances. The key risk of concern is that assets may be commingled between the life insurance activities and the non-life business. Such commingling creates potential risks for life insurance policy-holders and places a special duty of care on the governance mechanisms, particularly the management and supervisory board.

The IAIS Core Principles are unequivocal on this matter, specifying that separation is mandatory unless "the supervisory authority is satisfied that the insurer has satisfactory processes requiring that risks be handled separately on both a going concern and winding-up basis." This places a responsibility on the supervisor to assess insurers on a case by case basis, regardless of the legal regime. The EU Life Directive dealing with composites (mixed life and non-life insurance companies) provides more flexibility and, in addition, allows for grandfathered composites.²⁶ In the Czech Republic, the insurance legislation requires separation of life from non-life businesses under Article 7(6). However the law also provides an indefinite grandfathering of composites that were authorized as of April 1, 2000.

A further defence to protect policy-holders and other stakeholders is a strong external audit process. As noted in the assessment, the Czech legislation does not require that the external auditor review and express his/her opinion regarding regulatory returns such as solvency ratios and capital allocation. Another issue is that development of the Czech actuarial profession remains relatively slow. The supervisor is not in a position to access an independent review of the actuary's work or carry out its own check of the calculations, although the OSS/MOF is currently developing a program to strengthen its own actuarial capabilities. In addition the calculation of the solvency ratio is not sufficiently transparent to the public. For example, the use of subordinated debt can create confusion since subordinated debt may be considered a form of "quasi-equity": the minimum requirements for subordinated debt to qualify as solvency are defined in the relevant EU Directives and are included in the Czech enabling Decree. However, in the absence of transparency of the subordinated debt agreement, it is not possible for outside analysts to assess the quality of the capital, how it is allocated, and if part of the regulatory capital may be equity or may be debt: an insurer should be required to disclose in its audited financial reports whether subordinated debt qualifies under the solvency requirements.

²⁵ A copy can be downloaded at http://www.europa.eu.int/comm/internal_market/company/independence/index_en.htm

²⁶ The EU Life Directive can be downloaded at http://europa.eu.int/comm/internal_market/insurance/life-nonlife_en.htm

Czech legislation does require separate provisioning for life and non-life business, with separate asset registers and separate reporting to the MOF/OSS for the two types of business. Czech insurance companies must also ensure sufficient authorized capital to meet minimum solvency requirements for the life business separate from the non-life activities. However this assessment recommends that if life and non-life businesses are commingled, the published accounts should show the allocation of income, expenditure, assets, provisions, statutory capital and free funds and that this be audited by the external auditor according to the Insurance Accounts Directive. The requirement is already set out the EU Life Directive.²⁷

A further onus lies on the insurance supervisor in the Czech Republic because of the weak bankruptcy system, which allows substantial discretion to the bankruptcy trustee. While the issue has not yet been tested in the Czech insurance sector, court decisions involving cases in other parts of the financial sector suggest that in case of bankruptcy, and in the absence of a stronger separation of assets covering policyholder liabilities, it would be possible for the assets of life-policy holders to be allocated to policyholders of other types of insurance contracts from the same insurance company and even to other claimants. The bankruptcy legislation should be revised to protect life-insurance policy-holders against this outcome.

In addition Article 19(1) of the EU Life Directive requires that the insurance supervisor apply an enhanced level of oversight for insurance activities that are part of mixed conglomerates. While the Act on Financial Conglomerates provides sufficient authority to the supervisory bodies, the key issue will be implementation of the Act. Composites will continue to place special responsibilities on the insurance supervisors, who are obliged to ensure that adequate measures are in place to provide effective separation of these two very different types of businesses. In fact challenges concerning the protection of life policyholders are not restricted to composite insurance companies. Within insurance groups and financial conglomerates similar questions and problems appear, in particular with regard to capital links between companies, outsourced activities (such as information technology, investment function etc.) and reputational risk. The supervisory authorities will need to have sufficient adequately qualified people to carry out this role once the Conglomerates law becomes effective, although the requirement is already implicit in the Insurance Law and Decrees.

²⁷ Article 19 of the Directive notes that the separate management ... must be organised in such a way that the activities covered by this Directive are distinct from the activities covered by Directive 73/239/EEC in order that:
— the respective interests of life policy holders and non-life policy holders are not prejudiced and, in particular, that profits from life assurance benefit life policy holders as if the assurance undertaking only carried on the activity of life assurance, — the minimum financial obligations, in particular solvency margins, in respect of one or other of the two activities, namely an activity under this Directive and an activity under Directive 73/239/EEC, are not borne by the other activity, and
2. (a) Accounts shall be drawn up in such a manner as to show the sources of the results for each of the two activities, life assurance and non-life insurance. To this end all income (in particular premiums, payments by reinsurers and investment income) and expenditure (in particular insurance settlements, additions to technical provisions, reinsurance premiums, operating expenses in respect of insurance business) shall be broken down according to origin. Items common to both activities shall be entered in accordance with methods of apportionment to be accepted by the competent authority. (b) Assurance undertakings must, on the basis of the accounts, prepare a statement clearly identifying the items making up each solvency margin, in accordance with Article 27 of this Directive and Article 16(1) of Directive 73/239/EEC.

Detailed Assessment of the Corporate Governance Framework for the Insurance Sector: A Comparison of Rules and Practices against Proposed Benchmarks

The corporate governance benchmarks are divided into two groups: (1) internal elements of corporate governance within insurers, and (2) external factors that influence the corporate governance of insurers.

The internal factors are:

- 1) Management, i.e. the management board and other senior management;
- 2) Risk management systems and internal controls;
- 3) The responsible (or appointed) actuary; and
- 4) Oversight of management by the supervisory board.

The external factors are:

- 1) The insurance supervisory authority;
- 2) Public disclosure and market discipline;
- 3) External audit; and
- 4) Industry initiatives.

In addition, the benchmarks discuss special provisions related to insurance companies that are wholly or majority owned or controlled subsidiaries of foreign parent insurers or financial groups, or branches of foreign insurers.

	INTERNAL BENCHMARKS
	Section A – Management
Benchmark A.1	The management team as a whole, and each member of it, should have clearly defined responsibilities and the necessary authority to manage the insurer in a manner consistent with the strategic direction approved by the supervisory board. All members of the management team should be required to perform their duties with due care and diligence, and for the purpose of maintaining the insurer’s capacity to meet its obligations to all counterparties and constituencies at all times. Members of the management team should be free of material conflicts of interest that could unduly influence their judgment. Where management is constituted as a management board, no non-executives should be part of the management board.
Description	<p>The Bank Team found that the management teams of the insurance companies were professional, with clearly defined responsibilities and adequate authorities to fulfil their duties. Boards of directors (i.e. the management boards) consisted only of executives.</p> <p>Two acts cover the fiduciary duties of management teams. Section 194 of the Commercial Code requires that members of the board of directors conduct their duties with “due managerial care” and thus with due diligence. Section 194 also establishes joint and several liability for members of boards of directors and with Section 66 (2) clarifies that board members should conduct their duties in the interests of the company and its creditors (see footnote 15). Section 194 also requires that board members should not disclose confidential information or facts to third parties, if such disclosure might be detrimental to the company.</p>

	<p>The Act on Insurance provides for additional fiduciary duties for members of boards of directors. Article 4 (3) requires that the insurance undertaking conduct its activities prudently and in a way that would not damage the property entrusted to them by third persons (i.e. policy-holders) or endanger their security and stability or the security and stability of persons linked to the insurance undertaking. Under the Commercial Code, the statutory body of the insurance company is the board of directors.</p> <p>Articles 65 and 196 of the Commercial Code also stipulates limitations on competitive conduct for members of boards of directors and supervisory boards, but the code does not provide for other restrictions related to conflicts of interest. Section 12 of the Insurance Act prohibits members of Parliament, the financial regulators, or board members of other insurance companies from acting as members of the board of directors or supervisory board of a Czech insurance company.</p>
Recommendation	None
Benchmark A.2	Management should have sufficient skills and experience in relation to insurance, finance and other disciplines relevant to the management of an insurer. All members of the management team should have access to sufficient resources and receive sufficient training to assist them in the performance of their roles.
Description	The management of the major Czech insurance companies appears to be highly professional and demonstrates sufficient skills to fulfil their duties. The Bank Team did not review the management of the small locally-owned insurance companies that are not members of the insurance association.
Recommendation	None
Benchmark A.3	Members of the management team should be fully accountable to the supervisory board. The accountability should be clearly specified in the company statutes.
Description	<p>Article 187 of the Commercial Code states that the shareholders' meeting has the authority to appoint and recall members of the boards of directors (and supervisory boards) and set their remuneration—although the company statutes may authorize the supervisory board to appoint the management body. For limited liability companies, similar provisions are found in Article 125 of the Code.</p> <p>In practice, the supervisory boards of Czech insurance companies rarely (if at all) appoint senior management. The Bank Team did not review company statutes but found that in practice, the management team is primarily accountable to the dominant shareholder(s) rather than the supervisory board.</p>
Recommendation	In order to fully implement a dual-board structure, the senior management of Czech insurance companies should be hired and dismissed--and their remuneration set--by the companies' supervisory boards. At the same time, the supervisory boards should have some independent members to ensure that the interests of minority shareholders and long-term policyholders are addressed. The statutes of Czech insurance companies should be revised to clarify that supervisory boards have such responsibilities. This move of supervisory boards from a subordinate to a superior role would represent a radical change of practice and should be phased in over a suitable time frame.
	Section B - Risk Management Systems and Controls
Benchmark B.1	An insurer should have reliable risk management systems to identify,

	measure, monitor and control all business risks of the insurer. The risks should be assessed on both solo and consolidated bases (that is, among upstream parents and downstream subsidiaries and across borders). Key risks relate to credit, interest rates, exchange rates, basis risk, compliance risk, operations, reputation, exposures to related parties, liquidity concentration of exposures to single or grouped counterparties, sectoral, geographical or industry exposure concentration, and risks associated with criminal activity and money laundering. In large organizations, the risk management function should be a separate unit.
Description	The leading insurance companies appear to have reasonably sophisticated risk management systems in place, but the same may not be true of the second and third tier companies. Nevertheless none of the insurers appear to have established separate global risk management functions within their organizations. ČP lists sources of risk in its annual report and investment risks appear to be the responsibility of the Executive Director for Investments. Some foreign-controlled insurers and the major domestic firm all list internal audit functions in their organization charts. The subsidiaries of the large international groups appear to rely heavily on risk management systems imposed by their parent companies.
Recommendation	The major local insurance companies should be encouraged to establish dedicated risk management functions which are required to report to the supervisory board on a regular basis. Where subsidiaries rely heavily on risk management systems imposed by their parent companies the management board of the subsidiary should be satisfied that the systems are appropriate for the respective company.
Benchmark B.2	The insurer’s risk management systems should be subject to regular internal review, and periodic review by suitable, independent experts, to ensure that the systems are appropriate for the nature of its business activities and risks.
Description	The subsidiaries of the international groups all have effective internal functions for review of their risk management systems, and the Bank Team was advised that ČP has a sophisticated risk management system. However the company’s annual report does not describe the risk management processes.
Recommendation	Insurer annual disclosure documents should include a description of the company’s risk management systems, including the name of the responsible officer, whether COSO Enterprise Risk Management (ERM) principles have been adopted, and the specific risks monitored.
Benchmark B.3	The insurer should maintain effective internal controls, including internal audit arrangements, with adequate resources and independence.
Description	<p>The insurance legislation requires that insurance companies establish effective internal controls. Article 26c of the Act on Insurance requires that local insurance companies establish internal control systems that: (i) ensure the accuracy, integrity and verification of the insurer’s information, (ii) document risks associated with the activities and determine the probability of such risks occurring, (iii) stipulate both procedures to safeguard the correctness of the data and test its accuracy, (iv) verify compliance with the legislation, and (v) evaluate the efficiency and effectiveness of the company management in resource-utilization. Additional provisions are found in Articles 2 and 4 of the Act. However the implementing regulations have yet to be prepared.</p> <p>Nevertheless the leading Czech insurers appear to maintain adequate internal audit functions. The foreign-owned insurance companies rely on the control systems of their parent organizations. However, several of the foreign-owned insurers are parts of foreign financial conglomerates and it is not clear if the integrated control systems for the conglomerates also provide for sufficient local</p>

	<p>controls.</p> <p>Several insurance companies, including Allianz, Aviva and ING are parts of international financial groups listed on the US securities markets and thus are obliged to follow the internal controls provisions of the US Sarbanes-Oxley legislation, including at the level of the local subsidiaries.</p>
Recommendation	<p>Implementing regulations should ensure that the supervisory board has overview responsibility for internal controls. Where subsidiaries rely heavily on internal control systems imposed by their parent companies the management board of the subsidiary should be satisfied that the systems are appropriate for the respective company.</p>
Benchmark B.4	<p>The insurer should maintain reliable systems and controls for identifying, monitoring, and managing exposures to, and dealings with, related parties, including 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.</p>
Description	<p>Section 66a of Commercial Code requires disclosure of related party transactions, that is, agreements and contracts between controlling and controlled persons. The same section provides extensive discussion of direct and indirect control and decisive influence, noting, for example, that a person holding 40 percent or more of the voting shares of another entity is considered as a “controlling” person. Furthermore the report under Section 66a must be audited by an independent auditor.</p> <p>Article 26(d) of the Insurance Act requires that institutions subject to supplementary supervision submit a report to OSS before March 31st of the year following the reporting year. In addition the supervisor has extensive powers to carry out on site inspections of an insurer in a group (and related entities based with the Czech Republic) as part of its supplementary supervision responsibilities (Articles 26), however MOF/OSS applies a general do no harm rule rather than specifying the examination of limits on inter-group transactions.</p> <p>Publication of the Commercial Code related-party transactions report is uneven, with some insurance companies publishing the report as part of its annual report and others requiring that the reader of the report specifically ask for a copy from the company. For at least one major insurer (which does provide some disclosure in its annual report) related party transactions appear to approach the quantitative limits generally seen elsewhere: in many insurance markets, regulations limit total related party transactions to 10% or less of assets.</p> <p>The 2005 Act on Financial Conglomerates also includes some provisions on related-party transactions, for which the MOF/OSS has just begun to develop procedures for implementation.</p> <p>However the Czech Republic suffers from generally weak public disclosure of ownership and control of large corporations. In addition, the relationship between company executive management and dominant shareholders raises concerns over the quality of controls over related party transactions.</p>
Recommendation	<p>The insurance law (not a decree) should explicitly define related party transactions and should provide specific guidance on the maximum limits of related party transactions and other related rules such as valuation. In addition,</p>

	insurance companies should be required to include specific disclosure on individual related-party transactions and balances in the notes to their annual reports.
Benchmark B.5	For composites (i.e. companies offering both life and non-life insurance), assets covering life insurance liabilities should be completely segregated from all other assets and be first applied to meeting life insurance policyholders' entitlements in the event of a liquidation or portfolio transfer.
Description	<p>The insurance legislation required that separate companies be established to handle life and non-life business. However, despite the efforts of the supervisor, all composites existing at the time the law was passed have been indefinitely grandfathered, based on the option granted by the EU Life Insurance Directive as extended in 2004.</p> <p>The law requires that the supervisor is advised of the assets matching technical provisions six monthly but does not require the maintenance of accounts, selection of a method of ensuring policyholder precedence and ongoing maintenance of a register (under the first method) according to the EU insurance wind up directive (2001/17/EC, Article 10). The current insolvency legislation gives a trustee substantial discretion in the allocation of assets for bankrupt companies.</p>
Recommendation	In the spirit of the EU Life Insurance Directive, there should be full implementation and strict application of the relevant EU rules for composites including earmarking of assets and apportionment of income and expenditures based on a system approved by the supervisory authority.
	Section C – Responsible (or Appointed) Actuary
Benchmark C.1	Each insurance company should have a responsible (or appointed) actuary for each of its major lines of business (i.e. life, general insurance, health). The actuary should have specified skills, appropriate for the type of insurance for which he/she is responsible. The responsible actuary should be required to advise on levels of technical reserves, on the proper risk premium calculation of insurance products, prepare periodic analyses of surplus (profits) and advise on the distribution of surplus arising from long-term business (i.e. life insurance) and long tail business (i.e. general liability, worker's compensation and motor third party liability).
Description	<p>The qualifications for certification as an actuary are specified in the Insurance Law. In addition the concept of “Responsible Actuary” is embedded in the Law and MOF has approval authority. Responsible actuaries have a wide range of duties and responsibilities under Article 23 of the Insurance Act, including setting premium levels, determining and certifying insurance provisions and reserves and allocation of surplus in a life insurer. The responsible actuary also has a “whistle-blowing” responsibility if he or she cannot agree on a matter with management.</p> <p>The Czech Republic benefits from a small but very active and professional actuarial community. The concept of a “responsible” actuary is incorporated both in law and in practice. Some issues have evidently arisen with implementation due to confusion of the right to practice with the additional responsibilities implied in the title “Responsible Actuary”.</p>
Recommendation	The insurance legislation should clarify the special status of “Responsible Actuaries”. In addition the Responsible Actuary should be required to provide detailed advice, in writing, on the distribution of surplus.
Benchmark C.2	The actuary should be professionally certified and subject to best practice

	actuarial standards, continuous professional development (formal education), appropriate ethics standards and disciplinary proceedings. In all written reports, the actuary should be required to specifically state all assumptions and highlight any uncertainties.
Description	<p>The Czech actuarial profession (organized through the Czech Association of Actuaries) meets most of the requirements. However the Association has yet to prepare key professional standards, including a requirement that actuaries disclose their assumptions and identify levels of uncertainty. Perhaps the largest gap however is that there is as yet no standard for the format and presentation of actuarial reports, particularly regarding technical provisions and mathematical reserves and no requirement to prepare a financial condition report (FCR) for the boards and supervisor. As a full member of the International Actuarial Association, the Czech Association is, in principle, subject to its standards.</p> <p>There is a growing trend to set up actuarial standards boards with official status (for example in the UK, US, Australia and India) and this may be an option in the Czech Republic given the heavy dependence of the sector and the supervisor on actuarial certification.</p>
Recommendation	The Czech Association of Actuaries should prepare and publish a professional standard covering actuaries' reporting to management, boards and the supervisor and this should have the force of law. Such actions may require revision to the legislation to provide the Association with such authority.
Benchmark C.3	Management should recommend the levels of technical and mathematical reserves for the purposes of published and statutory reporting and this should be reviewed and approved by the supervisory board. The responsible actuary should have an advisory role and not be a member of the supervisory board. The actuary should also be independent of management in determining the assumptions underlying his or her recommendations regarding the levels of technical and mathematical reserves. All reports on reserving prepared by the responsible actuary should be made available both to the full supervisory board and the insurance supervisory authority.
Description	The Bank Team found that the specific role of the actuary differed from company to company. In two companies, the responsible actuary is also a member of the supervisory board, which is explicitly allowed under the Insurance Law. One company largely achieved the objectives of this benchmark through the establishment of a "Reserving Committee" consisting of selected members of the management team and supervisory board. The Bank Team also noted that the supervisory authority has broad access to the reports of the actuaries, allowing the authority to adequately monitor the assumptions used by the actuaries.
Recommendation	The role of the actuary should be to advise the management team and supervisory board. In order to fulfil the advisory role, the actuary should not be a member of the supervisory board. In addition, Czech insurance companies should be required to establishing reserving committees. Supervisory boards should also be required to formally review and approve the levels of technical provisions and mathematical reserves.
Benchmark C.4	The work of the responsible actuary involved in setting provisions and reserves for published accounts or regulatory returns should be subject to an effective independent review process. This requirement could be satisfied by a certified actuary employed by the external auditor.
Description	No formal review process is in place. Formal peer review is generally considered

	<p>best practice and has been introduced in a number of European countries and elsewhere²⁸. Other countries²⁹, are also considering a requirement for a formal review process. While it may be helpful for the external auditor to review the regulatory returns in the Czech Republic, not even the “Big Four” international auditing firms all have actuaries capable of reviewing regulatory returns.</p>
Recommendation	<p>A regulation should be put in place to require a formal peer review process for the review of actuarial reserving reports and recommendations. This peer review could be carried out by an actuary employed by the external auditor, which should in any case be responsible for signing off on the actuarially determined account values.</p>
	<p>Section D – Oversight of Management by the Supervisory board</p>
Benchmark D.1	<p>The supervisory board should have clear, well defined and well understood roles and responsibilities, including responsibility to approve the insurer’s strategic direction, oversee management, and take ultimate responsibility that the insurer is managed prudently.</p> <p>They should also ultimately be responsible for ensuring, through management, that the insurer has the capacity to meet its obligations to all counterparties, creditors and policy-holders at all times.</p> <p>The insurer’s founding documents should specify the process by which members of boards are appointed and discharged. Members of the supervisory board should legally be required to perform their duties with due care and diligence, and for the purpose of maintaining the long-term soundness of the insurer. Members of the supervisory board should be free of material conflicts of interest that could unduly influence their judgment.</p>
Description	<p>The Commercial Code says that the supervisory board of a joint stock company should: (i) supervise the activities of the executive officers, (ii) inspect the accounting reports and related documents, (iii) review the financial statements and proposed profit distribution and submit its opinion to the general meeting, and (iv) submit other reports as set by the company statutes. The official commentary for the section further clarifies that a supervisory board's main task is supervision and inspection. For insurance undertakings, no additional guidance is provided by the specific sector legislation.</p> <p>The role of the supervisory board of an insurance company in the Czech Republic does not cover approval of the company’s strategic direction. Nor is the supervisory board considered as the governing body assuming ultimate responsibility for the prudent management of the company. As noted in the European Commission’s February 2005 Recommendation on the Strengthening the Role of Non-Executive and Supervising Directors, two key responsibilities of the supervisory board are usually seen as: (i) ensuring that the financial reports and other related information disseminated by the company present an accurate and complete picture of the company’s position and (ii) monitoring the procedures established for the evaluation and management of risks. It is not clear that the provisions of the Czech Commercial Code require that supervisory board members to assume these functions.</p>

²⁸ For example, the UK and Canada

²⁹ Such as India and Australia

	<p>Also unclear are the full fiduciary duties of members of the supervisory board. In particular it is not clear if the higher fiduciary requirements of the Act on Insurance are also applicable to members of supervisory boards. It appears therefore that members of supervisory boards in the Czech Republic have limited obligations to policy-holders, which are not normally considered to be creditors in the absence of a current legal claim, and are treated as a special category in a number of leading jurisdictions. Indeed the Bank Team was advised that the supervisory board is legally responsible to the company’s shareholders only.</p> <p>With regard to the appointment of members of the supervisory board, the Commercial Code confirms that the shareholders’ meeting should appoint and remove (and approve the remuneration for) members of the supervisory board. However neither the insurance legislation nor other guidelines assist companies in establishing a clear, transparent and accountable process for appointment and removal of supervisory board members.</p> <p>With regard to conflicts of interest, the Commercial Code specifies that no executive officer of the company may also sit on the supervisory board. However Section 200 establishes that in companies with more than 50 employees, the company employees have the right to elect one-third of the members of the supervisory board. The Bank Team found that the provision was followed in most large insurance companies. Although “co-determination” is a common concept in countries that base their legislation on the dual-board structure, the presence of employees on supervisory boards has been widely criticized and is slowly being removed in the countries of central Europe. The presence of employees on a supervisory board presents a material conflict of interest—and still fails to provide adequate legal protection of employees’ interests.</p> <p>For foreign-owned companies, members of supervisory boards were often subject to substantial conflicts of interest. The supervisory boards of several insurers consisted entirely of non-resident executives from the parent companies.</p>
Recommendation	<p>The legislation should require that effective supervisory boards to be in place and their mandate to include approval of strategic direction and overview of the prudent management of the company. The fiduciary duties of boards of directors should also apply to supervisory boards. This is a system wide issue and would probably require amendments to the Commercial Code.</p> <p>In addition, supervisory boards of insurance companies should be free of conflicts of interest and in a position to effectively oversee the management function. The law or regulations (or possibly a code of conduct) should provide guidance on procedures for evaluation of the performance of supervisory board members and for their appointment and removal. In addition, the right of employees to elect members of the supervisory board should be periodically reviewed in light of peer country evolving practice. In particular, it is recommended that election of supervisory boards should follow the provisions of the pension law. That law allows employees to elect some members of the supervisory board but prohibits employees from sitting on the boards themselves.</p>
Benchmark D.2	<p>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. Members of the supervisory board should have adequate professional indemnity insurance (such as directors and officers insurance) provided by an insurance company independent from the insurance company concerned.</p>

Description	The Commercial Code establishes joint and several liability of members of supervisory boards. However, as is true of many former transition countries, the liability has not yet been tested in the local courts. Members of supervisory boards are not required by law or generally by company policy, to hold professional liability insurance (known as “D&O” or directors and officers insurance). However several insurance companies, including ČP and ČSOB do maintain D&O liability insurance for their board members.
Recommendation	Insurance companies should be encouraged to provide D&O insurance for the members of its supervisory board from unrelated insurers.
Benchmark D.3	The supervisory board should have a sufficient number of members to achieve broad based understanding of the insurer’s business activities and effectively discharge its responsibilities. Members should have the skills, experience and knowledge required to effectively perform their roles. Members should be able to devote sufficient time to their director duties as to make a sound contribution to the supervisory board’s functions. All members of the supervisory board should receive sufficient training to assist them in the performance of their roles and the insurer should provide induction programs for new members.
Description	<p>The Commercial Code notes that supervisory boards must have at least three members but the Code does not establish a maximum number of board members and in the case of one insurance company, the Bank Team found that the supervisory board had as many as 15 members.</p> <p>Articles 8 and 10 of the Act on Insurance reference the need for supervisory board members to submit information on their academic background and professional qualifications, but neither the legislation nor other guidelines specify minimum levels of experience or professional training.</p> <p>In addition, neither the company nor the insurance legislation includes provisions to ensure that supervisory board members devote sufficient time to complete their duties. In most countries, the legal provisions on joint stock companies require that supervisory boards meet at least four times a year. However the Czech legislation provides no such guidelines and the Bank Team found that one insurance company considered that semi-annual meetings of the supervisory board were sufficient.</p> <p>With regard to professional training, the insurance association provides some training of insurance company executives but neither the insurance association nor the Czech Institute of Directors is actively engaged in training of supervisory board members for insurance companies.</p>
Recommendation	Additional guidance should be provided for supervisory boards of insurance companies: possibly through legislation or regulation but preferably through a written insurance industry code of corporate conduct. While there is no agreed international standard on the number of members of a supervisory board, the size should be small enough that decisions can be taken efficiently. They should be required to conduct meetings at least quarterly and supervisory boards’ members should be required to undertake a minimum level of training to ensure that they are aware of both their statutory obligations under the law and international best practices for supervisory boards
Benchmark D.4	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 supervisory board committees. Even closely-held subsidiaries should have a minimum number of independent directors with specific responsibility to monitor related-party transactions, particularly with the parent company.
Description	<p>This issue is wider than the insurance sector. The EC’s February 2005 “Recommendation on the Strengthening the Role of Non-Executive and Supervising Directors” notes the importance of including non-executive or independent directors on the supervisory board, particularly with regard to dealing with situations involving conflicts of interest. Also under Section 66 of the Commercial Code, company supervisory boards have an obligation to review the related-party transactions report (required under Section 66) and report to the shareholders’ meeting. The Insurance Act also requires that the report (including descriptions of intra-company loans and expense sharing agreements) be submitted to the Ministry of Finance.</p> <p>In foreign-owned Czech insurance companies, the supervisory board is generally staffed by members of the executive management of the parent company. In the large locally owned company ČP, the supervisory board is chaired by a non-executive of the company and the board includes three non-executive members. A number of companies use the employee representative requirement of the Commercial Code to appoint members of management (such as the actuary) to the supervisory board. In general, the Bank Team found little evidence of independence among any members of the supervisory board.</p>
Recommendation	The EC Recommendations should be reviewed and incorporated in the legislation, regulations or guidelines provided for the insurance sector, in particular as regards the representation of non-executive and independent directors on the supervisory board.
Benchmark D.5	<p>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.³⁰ 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.</p> <p>Other desirable committees could include: (1) a risk management committee responsible for oversight of the insurer’s systems and controls for monitoring and managing risks; (2) a remuneration committee responsible for oversight of the remuneration and compensation arrangements for senior management, and (3) a nomination committee responsible for selecting members of the supervisory board. The supervisory board should ensure that incentive structures (including stock options) for insurance management are consistent with the insurer’s long-term soundness. The audit and nomination committees should comprise a majority of non-executive board members and be chaired by a non-executive and independent director.</p>
Description	The Bank Team found that audit committees were not generally part of

³⁰ 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.

	supervisory boards, although the insurer associated with one major bank (ČSOB) does have an audit committee with specific responsibilities.
Recommendation	Following international practice, insurance companies should be required to maintain audit committees and the committees should be composed largely of independent supervisory board members. The chairman of the audit committee should be independent and free of all material conflicts of interest.
Benchmark D.6	The supervisory board should maintain regular processes for reviewing its performance and that of each of the supervisory board members. The review processes should include periodic external review by independent experts.
Description	The Bank Team found that supervisory boards do not yet maintain processes for reviewing their own performance. The concept that supervisory boards should maintain processes for reviewing their own performance is a relatively recent development for corporate governance. At the current time, it may not be applicable to the Czech Republic but at a future moment will likely become appropriate for major Czech companies.
Recommendation	None at this time.
Benchmark D.7	Members of the supervisory board should be adequately remunerated. The remuneration arrangements should be transparent and consistent with the demands and liabilities attaching to the duties undertaken (e.g. committee work).
Description	None of the insurance companies publishes the levels of remuneration of supervisory board members, although the remuneration of individual board members can be calculated based on the company's filings with the business registry. While the Bank Team did not collect detailed information on remuneration of supervisory board members of all Czech insurance companies, it appears that one major company pays appropriate levels of remuneration. The Bank Team was also advised that some insurance companies hire specialized advisors to deal with the issues related to remuneration of supervisory board members. However the remuneration levels appear to vary widely from company to company.
Recommendation	Insurance companies should be encouraged to seek specialized advice from qualified consulting firms on the levels of remuneration generally paid for supervisory board members. Alternatively a transparency regime could be introduced.
	EXTERNAL BENCHMARKS
	Section E – Insurance Supervisory Authority
Benchmark E.1	The supervisory authority should have the legal capacity to impose corporate governance requirements on insurers where necessary. The supervisory authority should issue guidance to insurers on desirable corporate governance policies, practices and structures.
Description	The insurance legislation is silent on the issue of the role of the MOF/OSS in setting corporate governance requirements for Czech insurance companies.
Recommendation	The MOF/OSS should have the authority to set corporate governance and relevant disclosure requirements for insurance companies. This should, ideally, involve approving a Code developed by, or with the industry, rather than one imposed by the supervisor.
Benchmark E.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. The

	<p>supervisory authority should be able to identify the ultimate direct and indirect beneficial owners of an insurer where they exercise control or own significant blocks of shares. The authority should use comprehensive and sophisticated criteria for determining control.</p>
<p>Description</p>	<p>The insurance legislation provides for fit and proper provisions for significant shareholders, supervisory board members and senior management. Members of supervisory boards (as well as members of boards of directors and significant shareholders) must meet minimum test of “credibility”. Under Section 10a of the Act on Insurance, credible persons are those that have not been sentenced for criminal act during the prior 10 years. The Act on Insurance Intermediaries goes further and covers persons who have not been declared bankrupt and who for the prior 5 years was not member of the board of directors or supervisory board of a bankrupt company. Overall the fit and proper requirements fall well short of the IAIS and CNB requirements.</p> <p>Four of the largest insurance companies are owned by foreign financial corporations that are listed on their home stock exchanges. According to its annual report, ČP is controlled by a Netherlands based company which in turn is owned by a Czech national. It is subject to stock exchange rules and IFRS, since all of its corporate bonds are publicly traded.</p> <p>The insurance legislation provides for substantial authority for the supervisory authority to investigate the origin of capital for insurance companies. Article 7 of the Act on Insurance notes that an insurance undertaking may not be licensed if the Ministry of Finance has a “well-founded suspicion” that the capital or other financial resources of the insurance undertaking or reinsurance undertaking originate from criminal activity or from unidentifiable sources.</p> <p>Article 26b of the Act on Insurance allows an insurance company to request exclusion from supplementary supervision where the company has a seat in a non-member-country, for which legal obstacles exist on receiving the necessary information or where “the inclusion of its financial situation would be misleading for the exercise of the supplementary supervision.” This would appear to be in violation of the provisions of the Post-BCCI Directive, which requires that the competent authorities not authorize (or continue to authorize) an insurance undertaking where the authority is liable to be prevented from effectively exercising supervising functions by the close links between that undertaking and other natural or legal persons.</p> <p>The Directive on supplementary supervision requires that the competent authorities identify a coordinating authority that will take the lead in supervision of the conglomerate. The Directive also notes that the coordinator should identify the types of transactions and risks that the regulated entity should report on with regard to intra-group transactions and risk concentrations. The authority should also define appropriate thresholds based on regulatory own funds and/or technical provisions. It is not clear that the MOF/OSS has done so for the financial groups, and in particular, for the conglomerate in which ČP participates.</p>
<p>Recommendation</p>	<p>The insurance legislation should refine the definition of credible persons: the CNB criteria would provide a suitable guide in this regard.</p> <p>All of the provisions of EU Directives 95/26/EC (generally called the “Post-BCCI Directive”) and 2002/87/EC on supplementary supervision of mixed</p>

	conglomerates should immediately be fully implemented. The MOF/OSS and its successor should set appropriate thresholds and restrictions on intra-group transactions and risk concentrations by regulation. For mixed financial and non-financial conglomerates, the authorities should require that a clear group structure is a prerequisite to obtain and keep a licence and provide the supervisor with the authority to ask for appropriate changes of the group structure in order to meet this requirement.
Benchmark E.3	The supervisory authority should review each insurer’s statutes to ensure that they comply with any requirements it imposes. Insurers’ statutes and changes to them should be subject to supervisory authority approval or notification to the supervisor.
Description	The insurance legislation provides for adequate authority for the MOF/OSS to review company statutes and changes thereof. The MOF/OSS notes that review of company statutes is part of the supervision process.
Recommendation	None
Benchmark E.4	The supervisory authority should periodically evaluate (including through meetings with the audit committee, risk manager, and the internal auditor) each insurer’s internal controls and risk management systems, either directly or via independent parties it approves.
Description	While the Insurance Law specifies that the “manner of application” of internal controls is a supervisory matter, the Bank Team found little evidence of internal OSS procedures or guidelines covering this responsibility.
Recommendation	As noted above procedures for the on-site inspection of both internal controls and risk management systems should be prepared. The UK FSA guidelines could be used as a guide. On-site inspections should pay particular attention to internal controls and risk management systems.
Benchmark E.5	The supervisory authority should approve a list of accepted auditors for insurers on the basis of a transparent set of approval criteria. The insurer should notify the supervisory authority of any changes of auditors. The supervisory authority should meet with each insurer’s external auditors on a regular basis, including periodically without the insurer being present, to discuss the most recent audit results and corporate governance arrangements, internal controls and risk management systems and financial reporting arrangements of the insurer.
Description	The large insurance companies all use one major auditing firm (KPMG) which has in-house actuarial expertise. Auditors of insurance companies also include one-person audit firms, which may or may not have access to independent consulting actuaries. The Bank Team was advised that at least with KPMG, the MOF/OSS conducts regular meetings with the audit firm separate from the insurance companies.
Recommendation	The MOF/OSS should publish a list of acceptable audit firms (or at least audit firm eligibility criteria) for insurance companies, based on similar rules to those applying for banks. Where an auditor provides consulting services (particularly with regard to actuarial consulting), the MOF/OSS should apply strict conflict of interest provisions. Given the current concentration of actuarial skills, these provisions could be phased in.
Benchmark E.6	The supervisory authority should require each insurer to have a designated function for legal and regulatory reporting and compliance and that function should be obliged to draw to the attention of the supervisory authority any breaches of such requirements.
Description	Neither the insurance legislation nor the regulations of the MOF/OSS require a designated function for legal and regulatory reporting and compliance, although

	the Bank Team was advised that most insurance companies have designated a compliance officer.
Recommendation	The MOF/OSS should require that insurance companies establish a designated officer for legal and regulatory reporting and compliance.
Benchmark E.7	Where control of insurers by non-financial entities is permitted, or where an insurer is part of a non-financial conglomerate, the supervisory agency should require more stringent controls over related party transactions and a majority of independent directors on the supervisory board. Insurers should not be permitted to control or operate non-financial activities either directly or indirectly, in so far as those activities do not support insurance activities.
Description	<p>Apart from the fit and proper requirements as applied to controlling and significant shareholders, there are no legal provisions limiting non-financial control of insurance companies. Control of the largest insurance company is held by a mixed (financial and non-financial) holding company, which also controls industrial and commercial enterprises in the Czech Republic. The insurance company has no independent directors.</p> <p>The 2005 Act on Financial Conglomerates will provide the MOF/OSS with additional authority to establish controls over related-party transactions and provide the supervision required under the EU Directive on supervision of financial and non-financial conglomerates. Full application of the Directive would give the MOF/OSS the authority, if it wishes, to examine the assets of financial subsidiaries of the insurance company.</p>
Recommendation	The legislation should fully implement the Post-BCCI Directive of EU as well as the provisions of the Act on Financial Conglomerates. As lead regulator for major financial groups (such as PPF Holding), the MOF/OSS (and its successor) should issue regulations on related party transactions and concentrated risk exposures within financial and mixed conglomerates. The MOF/OSS should not continue to authorize insurance companies where the ultimate control structure cannot be easily understood and supervised.
Benchmark E.8	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 ensure 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.
Description	<p>The Commercial Code requires some disclosure of related party transactions and the Bank Team was advised that enabling law specifies quantitative limits on certain related party transactions. There appear to be no provisions for prior approvals for related party cash transfers.</p> <p>Local insurance experts advised the Bank Team that the general provisions of the company law are insufficient for the nature of the insurance sector, which should involve an enhanced fiduciary duty to policy-holders.</p> <p>Furthermore the Czech Republic suffers from generally weak public disclosure of</p>

	<p>ownership and controls of large corporations. Relationships between company executive managements and dominant shareholders should be a matter of concern.</p> <p>One major insurer has recently established a reinsurance subsidiary in Cyprus. While this is presumably for good strategic direction the supervisor should apply internationally accepted prudential standards to all Czech insurers' reinsurance placements.</p>
Recommendation	Restrictions on the aggregate level of related-party transactions should be set more stringently for mixed conglomerates and financial conglomerates than for single-purpose insurance companies. The MOF/OSS should require that, for major liability contracts, risks are placed on an “arm’s length basis” where insurance is provided by one entity within the conglomerate to another entity in the same conglomerate. Similar requirements, including adequate security should apply to intra-group reinsurance/ coinsurance arrangements.
Benchmark E.9	The supervisory authority should prepare and publish industry and company-specific information sufficient to allow financial analysts and insurance intermediaries to evaluate the financial performance and strength of insurers.
Description	The MOF/OSS publishes an annual report, which provides some summary information related to premium revenues and claims paid on a company by company basis. However this information is not sufficient for industry analysts to determine key performance ratios either for individual companies or for the sector.
Recommendation	The MOF/OSS should publish an annual report that covers extensive information on Czech insurance companies. For non-life business, such key information should include net and gross earned premium income, net incurred claims, distribution and administration expenses, operating and other investment income, loss ratios, operating ratios, and amounts of net technical provisions. Details of reinsurance contracts, which have commercial value, should be excluded from disclosure. For life insurance activities, the financial information should include business in-force, new business, business discontinued, claims and surrenders, investment returns on mean assets, expenses, and mathematical provisions ³¹ .
Benchmark E.10	The supervisory authority should require periodic reporting of asset movements and technical provisions movements at least quarterly. Reporting should be more frequent (i.e. daily or for each transaction) where corporate governance is weak or the insurer is under enhanced supervision. On at least an annual basis, and preferably semi annually the supervisory authority should prepare an analysis of solvency margins and technical reserves.
Description	Insurance companies are not required to provide regular reports of asset movements to the MOF/OSS. The MOF/OSS reviews the solvency margin of licensed insurance companies once a year and the technical reserves every six months unless the insurer is under enhanced supervision.
Recommendation	Reports on asset and technical provisions movements should be submitted to the supervisor on a regular basis (at least quarterly). Reports on major changes in the assets or technical provisions should be reported ad hoc or to shorter intervals.
	Section F – Public Disclosure and Market Discipline
Benchmark F.1	Insurers should be required to prepare financial statements in accordance

³¹ Suitable templates include the current Turkish and original Australian supervisors’ statistical reports. (Australia’s largest insurance failure occurred after these reports were reduced in scope under industry pressure). The US statistical reports are probably too detailed at this stage.

	<p>with international financial reporting standards (IFRS) on both a solo and consolidated basis. If more frequent financial reporting (than annual) is required, the reports should be publicly available. Where disclosures are not covered by IFRS, the supervisory agency should have the authority to set additional requirements. Pending the introduction of the Solvency II regime, the supervisory agency should require annual stress-testing as a supplementary solvency measure where assets and liabilities have a significant fair value component.</p>
<p>Description</p>	<p>Most insurance companies in the Czech Republic prepare their financial statements in accordance with Czech Accounting Standards (CAS) which differ from IFRS. The numerous small Czech insurers prepare their statements using CAS alone. The Czech subsidiaries of international financial groups prepare their statements using CAS, which are then converted to IFRS to allow the group to prepare their financial statements.</p> <p>Starting in 2005, publicly traded companies have been subject to the EU requirement to prepare consolidated financial statements using IFRS endorsed by the EU Commission (that is, all IFRS except certain parts of IAS 39). The combined effect of the limited number of insurance company listings, the consolidation exemption of the EU 7th Directive and IFRS³², and the IAS 39 carve-outs will limit the availability of full IFRS-based financial statement information for stakeholders in Czech insurance companies.</p> <p>Similar to the UK, the Czech Republic has adopted asset and liability valuation bases with significant fair valued components, although this supplements a requirement that liabilities be valued at the pricing (or ‘technical’) interest rate. With interest rates being relatively low the fair value approach applies in practice. There is a requirement that supplementary reserves be established if future asset earning power will be inadequate to meet liabilities, but a supervisory methodology is not specified. Thus, unlike the UK no statutory stress or resilience testing is required to ensure that life insurer balance sheets can withstand substantial shocks, although the Bank Team was advised that leading insurers do carry out such prudential checks and report the results.</p> <p>Insurance companies provide annual reports to the MOF/OSS on solvency ratios but the reports are not available to the public. The insurance law provides for no authority for the MOF/OSS to require additional disclosure.</p>
<p>Recommendation</p>	<p>Regardless of whether or not they have publicly-traded securities, all financial institutions (including not only insurance companies but also banks and investment and private pension funds) should be considered as “Public Interest Entities” and required to prepare their financial statements in accordance with IFRS. Ideally companies should be able to prepare IFRS-compliant statements and not be obliged to prepare a second set of CAS-compliant statements. The issue of the need to prepare two sets of financial statements arises in most post-transition economies. In some countries small enterprises are allowed to rely on tax accounts. However insurers are generally considered to be public interest enterprises. They need to be a minimum size to be efficient and should be</p>

³²The EU 7th Directive and IFRS contain the exemption so that companies in a group that are required by law to publish financial statements under IFRS, in addition to the group’s consolidated financial statements, would not be unduly burdened. However, the EU and IFRS exemptions are conditional upon several conditions, including the availability of the group’s consolidated financial statements and the approval of minority shareholders. The Czech exemption does not include these fundamental conditions, which may have an adverse impact on the transparency of financial reporting.

	<p>required to adapt to modern transparency requirements regardless of market share. The issue would benefit from additional analysis.</p> <p>While the introduction of Solvency II may still take some time, the MOF/OSS should immediately start to require stress-testing by all life insurers to ensure that balance sheet can withstand shocks such as changes in interest rates.</p>
Benchmark F.2	<p>Insurers should be required to prepare annual reports. The annual report should include: (1) the full financial statements, including comprehensive notes and the auditor’s opinion, (2) meaningful statements by the supervisory board and management of the performance of their responsibilities, and (3) a statement describing the major risks of the business and how these are managed. The annual report, and other more frequent disclosures as required by the supervisory authority, should be publicly available regardless of whether or not the insurer is listed or otherwise publicly traded. Life-insurers should annually disclose sources of surplus/ deficit.</p>
Description	<p>The insurance companies all publish annual reports. While the content varies among companies, they all appear to include basic financial data, and the Bank Team was advised that some of the reports do provide sufficient information to accurately calculate key ratios such as loss and operating ratios or to properly analyze cash flows. Most annual reports do not describe the activities or performance of the supervisory board or company management.</p> <p>While disclosure practice on risks varies among the Czech companies, even the best practice fails to provide sufficient information for financial analysts and intermediaries to quantify the risks. However returns submitted to the MOF/OSS are not available to the public. While insurance companies are required to follow Decree No. 502/2002 Coll., the Bank Team found that in their annual reports some companies appear to mix accrued amounts with paid amounts in the summary tables. (Note that the issue is complicated by the fact that in the Czech language, the term “paid” can also mean “accrued.”)</p> <p>Annual financial reports are available to the public. Life insurers are not required to publicly disclose the sources of annual surplus.</p>
Recommendation	<p>As a way of improving public disclosure and market discipline, insurance companies should be obliged to annually publish: (i) statements by the supervisory board and management of the performance of their responsibilities, (ii) statement describing the major risks of the business and how these are managed, (iii) sources of annual surplus for life insurers, and (iv) notes which are sufficiently comprehensive that a trained analyst can properly assess the real performance of the institution and trends in performance.</p> <p>The MOF/OSS should also establish a standard methodology for calculating key ratios and otherwise review the structure of published statistics by insurance companies. In addition the Association of Insurers should compile the information from their members and then publish it in a form which can be used to produce key ratios for the non-life sector.</p>
Benchmark F.3	<p>Additional corporate governance disclosures do not need to be audited but at a minimum should include: (1) annually, listing of the names and roles of supervisory board members and key senior managers and their major affiliations and remuneration (by bands), (2) authorities and responsibilities of the company’s governing bodies, and (3) annually, identity of controlling</p>

	or otherwise significant direct and indirect beneficial owners of the insurer. As they occur, any significant changes in the aforementioned should be reported in a widely-read newspaper recognized as an official publication under by the national law. All disclosure statements required should be easily accessible by the general public, including on an insurer’s website where one exists.
Description	Additional disclosure varies by company and tends to be reasonably strong among the leading companies. However ultimate beneficial shareholders are not disclosed. In addition, companies do not generally disclose the authorities of governing bodies (although copies of the company charter can be obtained from the company, upon request, or may be obtained from the company register.) Remuneration of board members or managers is disclosed in total under law, and in more detail in some but not all insurance companies.
Recommendation	The legislation should require publication of major (it will probably not be possible to know other indirect shareholders than those who have to notify their participation – in the EU a 10% limit applies) ultimate beneficial indirect shareholders of all insurance companies. In addition, as the corporate governance culture further develops in the Czech Republic, remuneration of individual board members and key managers should be disclosed by bands, as is already the case with ČP.
Benchmark F.4	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.
Description	Some insurance companies include the signatures of the CEO and CFO on the financial statements but there are no legal requirements.
Recommendation	To ensure that all Czech insurance companies follow good practice, the CEO and CFO of the insurance company should be obliged by law to sign the disclosure statements and attest to their accuracy and completeness.
Benchmark F.5	The regulatory structure should not impede contestability and competitiveness in the insurance sector, subject to ensuring that all insurer applicants meet the standards required for entry as an insurer. Regulatory and supervisory measures should not differentiate between like-institutions unless required for prudential reasons or the maintenance of a sound and efficient financial system.
Description	The high levels of profitability of the Czech insurance sector would suggest the presence of a less-than-fully competitive market for insurance products. This may be a reflection of the stage of market development. Nevertheless contestability can be improved by strengthening the disclosure regime for insurance companies in the Czech Republic. Other regulatory requirements appear not to inhibit contestability or competitiveness in the market for most classes of insurance. Workers’ compensation is restricted to just two insurance companies that operate on an agency basis on behalf of the state.
Recommendation	As noted throughout the assessment public disclosure should be strengthened. In addition there may be grounds for further privatizing workman’s compensation insurance once the other recommendations of this report are implemented.
Benchmark F.6	Policyholder guarantee schemes should not be established unless there is an adequate supervisory and governance environment. Such schemes in any event should not unduly encourage moral hazard.
Description	The Czech Republic has no industry wide guarantee scheme aside from the usual MTPL nominal defendant arrangement. The EU has prepared a discussion paper on guarantee arrangements but the Czech

	supervisory framework would need to be strengthened considerably before such a scheme could be introduced, assuming a fully competitive market.
Recommendation	The Czech Republic should monitor developments but not take further action at this time.
Benchmark F.7	The supervisory authority should consider the possible feasibility, costs and benefits of alternative mechanisms for strengthening market disciplines on insurers that are wholly or majority-controlled by a parent entity. Leading insurance companies should seek internationally accepted claims-payment ratings, and where applicable, credit ratings.
Description	While Czech companies are not formally required to obtain ratings of financial capacity, three companies have obtained such ratings. In addition the largest insurance company (ČP) has received debt ratings from Standard & Poor's and Fitch, although the latter has recently been replaced by Moody's Investors Service. ČSOB also has a debt rating from Standard & Poor's.
Recommendation	The largest of the Czech insurance companies should be encouraged to obtain and publish claims-payment ratings, and if applicable, credit ratings.
Benchmark F. 8	An active independent financial press should be in place and willing and able to comment on financial activities and market conduct of insurance companies.
Description	The Czech financial press is still becoming acquainted with complex insurance issues and is not yet considered to be an effective mechanism for governance of the financial sector. In the case of the largest insurance company, the financial press has alleged control of a major media outlet that was sold in early 2005. As more information on insurance companies becomes available to the public, the quality of financial reporting is expected to improve.
Recommendation	As noted throughout the assessment, public disclosure should be strengthened.
	Section G - External Audit
Benchmark G.1	Financial information in insurer disclosure statements should be audited by an independent external auditor at least annually.
Description	Article 39 of the Commercial Code requires that the annual financial statements of all joint stock companies receive an annual audit.
Recommendation	None
Benchmark G.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.
Description	In the Czech Republic, national auditing standards, issued by the Czech Chamber of Auditors, are used rather than ISA. Fortunately the audit regulations endorsed by the Chamber for 2005 audits are direct translations of ISA and the recently issued ethical code is based on the IFAC Code of Ethics. Accounting systems and systems of internal controls of Czech insurance companies are generally subject to an annual audit. However no process exists for certifying auditors as being competent to apply ISA and there is no public oversight body for national auditors. Unlike the CNB, OSS does not have the power to determine which audit firms may act as external auditors for insurance companies.
Recommendation	Once the 8 th Company Law Directive is enacted in the European Union, a national oversight body for the auditing profession should be created to comply with the Directive. The insurance supervisor should, at the very least, have the power to establish criteria which external auditors have to meet in order to be able to audit

	insurers.
Benchmark G.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.
Description	<p>The large insurance companies are all audited by international “Big Four” audit firms, with one firm providing audit services for four out of the five largest insurers. However the small insurers tend to employ small local auditing firms or single individuals as their external auditors. The Bank Team was advised that the reviews prepared by small firms or single individuals may not be adequate to ensure a fully-reliable audit.</p> <p>There are no legal provisions or common practices on rotation of audit partners, although the recently adopted ethical code (modelled on the IFAC Code of Ethics) requires that for all listed companies, audit partners be rotated every seven years.</p> <p>The Bank Team was not informed of any cases of inadequate separation of audit from non-audit services. Audit fees are not generally disclosed.</p>
Recommendation	All insurance companies in the Czech Republic should be subject to a comprehensive audit by a reputable auditing firm—and one that has the capacity and expertise to review the work of the insurer’s responsible actuary. It may be helpful if the MOF/OSS has the authority to establish criteria which external auditors have to meet in order to be able to audit insurers. In addition, audit partners for insurance company audits should be obliged to follow the rotation requirements applicable to listed companies, i.e. every seven years.
Benchmark G.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.
Description	Section 15.5 of the audit legislation requires that auditors report to the board of directors and supervisory board any economic crime, corruption or crime against assets of which they become aware. In addition auditors have ‘whistle-blowing’ responsibilities to the MOF in the event that certain financial difficulties are discovered. Section 24 of the Act on Insurance also requires that auditors submit an annual written report to the MOF/OSS and there are further requirements under the Act on Auditors.
Recommendation	None
Benchmark G.5	The engagement letter for the external audit should be approved by the audit committee of the supervisory board. At the end of the external audit process, the auditor should prepare a management letter, to which the insurer’s management should prepare a formal response. The management letter and management’s responses should be reviewed by the audit committee and should be presented to the supervisory authority upon request by the authority.
Description	The supervisory board generally does not review the management letter or management’s responses, although copies are generally sent to the parent company and to the MOF/OSS.

Recommendation	The insurance legislation or regulations should require that the supervisory board review the management letter and management's responses.
Benchmark G.6	Regulatory information submitted by an insurer should be audited at least annually by the external auditor where not already subject to audit.
Description	While the annual report with the company's financial statements are audited by an external auditor, the regulatory returns are not subject to an audit, although audit firms generally review the technical provisions as part of the external audits.
Recommendation	The insurance legislation should require that key regulatory returns should be audited by the external auditor.
	Section H - Industry Initiatives
Benchmark H.1	The insurance sector should establish an insurance association. The association should promote good corporate governance practices, including the development of benchmarks and possibly a voluntary code, and training programs for insurance supervisory board members.
Description	The Czech Insurance Association covers 27 out of 39 of the insurance companies and 99 percent of all premium income in the Czech Republic and identifies its primary mandate as one of advocacy for the sector. The Association is an active member of the European Insurance Committee, Comité Européen des Assurances (CEA). The Association advised the Bank Team that it is working on an amended Code of Ethics for the insurance sector. In addition it has recommended a corporate governance code, based on the code adopted by the Czech Securities Commission (CSC). The Association has carried out a number of seminars on insurance related law and promulgates technical information. However to date these seminars have not specifically focused on the statutory obligations of board members.
Recommendation	The Czech Insurance Association, possibly working with the Institute of Directors and MOF/OSS, should be encouraged to develop corporate governance benchmarks and training.
Benchmark H.2	Institutes of directors should be encouraged to provide guidance on desirable corporate governance practices and training for supervisory board members, in possible cooperation with the insurance association.
Description	The Czech Institute of Directors is active in providing training and corporate governance guidelines for members of supervisory boards but does not actively cooperate with the insurance association.
Recommendation	The Czech Institute of Directors should be encouraged to work with the insurance association to develop a cadre of directors capable of fulfilling supervisory board responsibilities for insurers.
Benchmark H.3	National stock exchanges should incorporate strong corporate governance provisions in their listing rules.
Description	The CSC has prepared a corporate governance code in consultation with the Prague Stock Exchange (PSE) and market participants. Listed companies generally disclose their compliance with the code but there are no relevant requirements. Companies on the parallel market generally do not provide the same levels of disclosure.
Recommendation	The PSE should amend listing rules to require statement of compliance with relevant corporate governance codes. The MOF/OSS should review the Corporate Governance Code to determine its applicability to non-listed insurance companies and to determine if a separate code of conduct should be prepared for insurance companies and intermediaries.
	Section I - Special Issues Relating to Wholly or Majority Foreign Owned or

	Controlled Insurance Subsidiaries and Branches
Benchmark I.1	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.
Description	For some of the foreign-owned insurance companies, the management board technically reports to the local supervisory board, but the supervisory board generally consists of executives of the parent company, who by definition are not independent.
Recommendation	See recommendations on role of supervisory boards.
Benchmark I.2	The host supervising authority of a branch of a foreign insurer should ensure that the head office of the insurer exercises appropriate control over the branch.
Description	All major foreign insurers are EU-based and are thus subject to relevant EU requirements.
Recommendation	None
Benchmark I.3	Legal title to the assets covering the policy-holder liabilities of a foreign insurer's subsidiary should be in the name of the subsidiary rather than the parent. For a foreign insurance branch, the host supervisory authority should satisfy itself that the branch assets are legally available to meet its liabilities, in the case of head office failure.
Description	Legal title to the assets covering the subsidiary's liabilities is held by the subsidiary. The MOF/OSS does not review the registration of assets held for branch liabilities.
Recommendation	The MOF/OSS should review the registration of assets held for branch liabilities (within the EU context).

List of Recommendations

INTERNAL BENCHMARKS

A. Management

- The senior management of Czech insurance companies should be hired and dismissed, and their remuneration set, by the companies' supervisory boards. The statutes of Czech insurance companies should ultimately be revised to clarify that supervisory boards have such responsibilities. However as this recommendation involves a fundamental upgrading of the role of the supervisory board, a suitable, relatively long term, transition plan would be required.

B. Risk Management Systems and Controls

- Those members of management responsible for the risk management and compliance functions should be required to report to the supervisory board on a regular basis.
- Insurer annual disclosure documents should include a discussion of the company's risk management systems.
- Implementing regulations should ensure that the supervisory board has overview responsibility for internal controls.
- The insurance law should define and limit related party transactions. In addition insurance companies should be required to include specific disclosure on individual related-party transactions and balances in their annual reports.
- The insurance legislation should be revised to strengthen the rules on asset segregation and proper apportionment of income and expenditures within a reasonable time frame for existing composites. Furthermore, supplementary supervision should be upgraded for defined insurance groups and conglomerates, and adequate resources provided to the relevant supervisory bodies.

C. Responsible (or Appointed) Actuary

- The insurance legislation should clarify the special status of responsible actuaries. The responsible actuary should be required to report in detail on the emergence of surplus, preferably in the context of a full written financial condition report. However the external auditor should have ultimate responsibility for signing off on all accounts.
- The Czech actuarial profession should prepare and publish a professional standard covering actuarial reporting to management, boards and the supervisor.
- One role of the actuary should be to advise the management team and supervisory board. In order to fulfill the advisory role, the actuary should not be a member of the supervisory board. Czech insurance companies should be required to establishing reserving committees.
- A regulation should be put in place to require formal peer review process for the review of actuarial reserving reports and recommendations. This could be carried out by actuaries employed by the external auditor.

D. Oversight of Management by the Supervisory Board

- The legislation should require that effective supervisory boards should be in place and their mandate should include approval of strategic direction and taking ultimate responsibility for the prudent management of the company. The fiduciary duties of boards of directors should also apply to supervisory boards.

- Supervisory boards of insurance companies should be free of conflicts of interest and in a position to effectively oversee the management functions. The law or regulations (or possibly a code of conduct) should provide guidance on procedures for evaluation of the performance of supervisory board members and for their appointment and removal. In addition, the right of employees to elect members of the supervisory board should be periodically reviewed in light of peer country evolving practice.
- Insurance companies should be encouraged to provide independent D&O insurance for the members of its supervisory board.
- The statutes of insurance companies should specify that shareholders' meeting shall appoint the members of the supervisory board and the supervisory board shall appoint the chief executive officer.
- Additional guidance should be provided for supervisory boards of insurance companies: possibly through legislation or regulation but preferably through a written insurance industry code of corporate conduct. Insurance companies should be limited to a maximum number of supervisory board members (such as nine). They should be required to conduct meetings at least quarterly. The members of the supervisory board should be required to undertake a minimum level of training to ensure that they are aware of both their statutory obligations under the law and best practices among supervisory boards of other countries.
- The EC's February 2005 "Recommendation on the Strengthening the Role of Non-Executive and Supervising Directors" should be reviewed and incorporated in the legislation, regulations or guidelines provided for the insurance sector as appropriate.
- Following international practice, insurance companies should be required to maintain audit committees. The committees should be composed largely of independent supervisory board members. The chairman of the audit committee should be independent and free of all material conflicts of interest.

EXTERNAL BENCHMARKS

E. Insurance Supervisory Authority

- The MOF/OSS should have the authority to set corporate governance and relevant disclosure requirements for insurance companies that involves approving a Code developed by, or with the industry, rather than one imposed by the supervisor.
- The insurance legislation should refine the definition of credible persons to be consistent with NBS requirements.
- The MOF/OSS should set appropriate thresholds and restrictions on intra-group transactions and risk concentrations by regulation. For mixed financial and non-financial conglomerates, the authorities should obtain all relevant information on the group or conglomerate structure that is necessary to effectively discharge supervisory functions.
- Procedures for the on-site inspection of internal controls and risk management systems should be prepared. On-site inspections should focus particularly on internal controls and risk management systems.
- The MOF/OSS should approve a list of accepted audit firms for insurance companies, based on similar rules to those applying for banks.
- Insurance companies should be obliged to establish a designated function for legal and regulatory reporting and compliance.
- The legislation should fully implement the Post-BCCI Directive of EU as well as the Directive on Supervision of Conglomerates. As lead regulator for major financial groups, the MOF/OSS should issue regulations on related party transactions and concentrated risk exposures within financial and mixed conglomerates.

- The MOF/OSS should publish an annual report that covers extensive information on Czech insurance companies. For non-life business, such key information should include net and gross earned premium income, net incurred claims, distribution and administration expenses, operating and other investment income, loss ratios, operating ratios, and amounts of net technical provisions. Details of reinsurance contracts, which have commercial value, should be excluded from disclosure. For life insurance activities, the financial information should include business in-force, new business, business discontinued, claims and surrenders, investment returns on mean assets, expenses, and mathematical provisions.
- Reports on asset and technical provisions movements should be submitted to the supervisor on a regular basis (at least on a quarterly basis). Reports on major changes in the assets or technical provisions should be reported ad hoc or in shorter intervals.
- Only financially strong reinsurers should be accepted for solvency purposes. The 1998 OECD Recommendation on the Assessment of Reinsurers or equivalent would provide a suitable standard.

F. Public Disclosure and Market Discipline

- All insurance companies should be required to prepare their financial statements in accordance with EU listed company requirements on both a solo and consolidated basis. Until the introduction of Solvency II, the MOF/OSS should require stress-testing by all life insurers to ensure that balance sheet can withstand shocks.
- As a way of improving public disclosure and market discipline, insurance companies should be obliged to annually publish: (i) statements by the supervisory board and management of the performance of their responsibilities, (ii) statement describing the major risks of the business and how they are managed, (iii) sources of annual surplus for life insurers, and (iv) notes which are sufficiently comprehensive that a trained analyst can properly assess the real performance of the institution and trends in performance.
- Remuneration of individual board members and key managers should be disclosed by bands.
- The CEO and CFO of the insurance company should be obliged by law to sign the disclosure statements and attest to their accuracy and completeness.
- The Czech supervisory framework should be strengthened considerably before the EU's proposals on policyholder guarantee schemes are introduced. The Czech Republic should monitor developments but not take further action at this time.
- Czech insurance companies should be obliged to obtain and publish financial strength ratings, and if applicable, credit ratings.

G. External Audit

- Once the 8th Company Law Directive is enacted in the European Union, a national oversight body for the auditing profession should be created to comply with the Directive.
- Audit partners for all insurance companies should also be obliged to follow the rotation requirements applicable to listed companies.
- The insurance legislation or regulations should require that the supervisory board review the management letter and management's responses.
- The insurance legislation should require that key regulatory returns be audited by the external auditor.

H. Industry Initiatives

- The Czech Insurance Association, possibly working with the Institute of Directors and MOF/OSS, should be encouraged to develop specific corporate governance benchmarks and training for board members.

- The PSE should amend listing rules to require statement of compliance with relevant corporate governance codes. The MOF/OSS should review the Corporate Governance Code to determine its applicability to non-listed insurance companies and to determine if a separate code of conduct should be prepared for insurance companies and intermediaries.

I. Special Issues Relating to Wholly or Majority Foreign Owned or Controlled Insurance Subsidiaries and Branches

- The MOF/OSS should review the registration of assets held for branch liabilities.

Confederation Life Case Study³³

Summary

Confederation Life made the fatal error of concentrating its assets in the real estate market at a time when real estate prices were inflated.

In order to make a profit in the increasingly competitive insurance industry, Confederation Life invested heavily in real estate throughout the 1980s and early 1990s. By 1993, 71 percent of the company's assets were in real estate. The performance of the real estate market appeared to be too good to be true - and it was. The losses began to hit hard in the early 1990s.

Between 1990 and 1993, appraised values fell from an average of \$208 per square foot to \$129 per square foot (based on properties held over the entire period), and a \$200 million portfolio Confederation had assembled for various pension funds lost 34 percent of its value during the same time period. The company's problems were compounded by poor management in its business practices. Among these were lax application standards for loan applicants, and company employees who bought condominium units from the company, then sold them back at a considerable profit a short time later.

Ultimately, federal officials, fearing investor panic, stepped in and shut the company down. KPMG, the liquidators, estimated losses at \$1.3 billion.

Overview

In late 1993, Confederation Life Insurance Company ranked fourth among Canadian life insurance companies with 273,000 policy-holders, 4425 employees, and \$19 billion in assets. A.M. Best Co., a leading ratings service for insurance companies, rated Confederation as "A (excellent)", the third-best of 15 possible ratings.

Executives at competing insurance companies have said that they knew Confederation was having some problems at that time, but nothing that couldn't be resolved - or so they thought. The problems stemmed from economic conditions in the early 1980's. At that time, competitiveness in the Canadian insurance industry was increasing, as insurance companies battled not only each other, but also mutual funds, banks, and trust companies for consumers' money.

This led to decreasing profit margins, which, coupled with rising inflation rates, meant that pension fund managers had to be on their toes in order to provide customers with the returns they expected and still turn a profit for themselves. Confederation's CEO and Chairman decided that the best strategies were to:

- Increase volume to achieve economies of scale;
- Establish new ventures; and
- Invest as much as possible in the real estate market, which was yielding impressive returns at that time.

In 1982, Confederation had a mere \$119,000 invested in property, but thanks to aggressive real estate investment, this sum had grown to \$1.1 billion by August 1994. Likewise, Confederation's mortgage portfolio grew from \$1.2 billion in 1982 to \$8.5 billion in 1993. The company had 71 percent of its assets, far more than any of its rivals, invested in real estate, either through direct ownership or through mortgages on properties ranging from houses to condominiums to office buildings and shopping malls.

³³ Reprinted with the kind permission of BancWare ERisk (www.erisk.com). BancWare ERisk is a division of SunGard (www.sungard.com).

In addition to the risks associated with having such a large proportion of the portfolio concentrated in one market, Confederation arguably couldn't have picked a worse time to make its foray into real estate. The real estate market was inflated, and the amazing returns could not continue forever. The losses hit hard in the early 1990's: between 1990 and 1993 appraised values fell from an average of \$208 per square foot to \$129 per square foot (based on properties held over entire period). A \$200 million portfolio that Confederation had assembled for various pension funds lost 34 percent of its value during the same time period.

If this lack of diversification and broad exposure to market risk weren't enough, Confederation also was plagued by poor management in its business practices. Perhaps the biggest liability in this respect was the Confederation Trust Company, which was set up in 1987 to provide loans to condominium promoters. Through partnerships with other companies, such as the Reemark Group in Southern Ontario and British Columbia, the company quickly grew its mortgage portfolio. For example, Confederation financed loans made through Reemark to the tune of about \$350 million. Unfortunately, neither Confederation nor Reemark was thoroughly checking where these loans were going. In fact, many were going to buyers of apartments who were not planning to live there and had no chance of even breaking even unless rents and values rose - but they were granted large mortgages with down payments of as little as \$1,000 per unit.

By 1989, the trust company had \$906 million in mortgages. Over the next three years, it lost \$89 million, mostly due to defaults on loans, and received \$70 million in capital from Confederation Life. Ultimately, Confederation Trust had to be shut down.

Confederation reported impressive profits of over \$100 million per year in 1989 and 1990. But problems were starting to become apparent by 1992, with the company reporting a mere \$1.9 million in profits for that year. In the fall of 1993, Confederation announced that it needed help and opened its books to competitors who might be interested in a merger, take-over, business alliance, asset purchase, or almost about any other kind of financial assistance.

Great-West Life Assurance Co. of Winnipeg expressed interest in the company in October, and in December agreed to try to work out a deal to save or absorb Confederation, on the condition that Confederation stop talking to all other companies. Confederation agreed. However, the proposed deal never materialized.

In July 1994, Great-West announced that it would not be able to act alone. Great-West stated that Confederation needed \$600-million in funds, and that Great-West would put up no more than \$75 million. On July 23, Canada's six leading life insurers began planning a joint rescue of Confederation. The insurers had an incentive to help, since if Confederation failed, they would pay the costs of compensating Confederation's policy-holders, via the industry fund that existed for this purpose. However, the negotiations between the rival insurers stalled, and on August 11 the Canadian government stepped in to shut down Confederation, fearing that public anxiety would lead Confederation customers to initiate massive withdrawals and cancellations, a similar process to "a run on a bank".

Confederation's individual life insurance policy-holders will fare relatively well, since death benefits up to \$200,000 are guaranteed by the Canadian Life and Health Insurance Compensation Corp., an industry-sponsored fund. About 90 percent of Confederation's policies are fully covered by this limit. Larger policies will be paid out at a somewhat reduced rate, but Comp Corp is optimistic that the reduction will be as little as 10 percent. Deferred annuities and accumulated cash values that customers can claim when they cancel their coverage are insured only up to \$60,000, and so may present a stickier situation.

Ultimately, all policy-holders will likely experience increased costs passed down to them from the remaining insurers, who must cover Confederation's debts through contributions to the Comp Corp fund. Counterparties to Confederation's interest rate and foreign exchange derivatives transactions also felt the pain; it is estimated that these aborted contracts ran into hundreds of millions of dollars.

Events

Early 1980s: Confederation decides to aggressively purchase real estate to be able to provide competitive returns in the life insurance business.

1987: Confederation Trust is established to provide mortgages on condominiums.

1989, 1990: Confederation reports profits exceeding \$100 million in each of these years.

1992: Confederation reports an annual profit of \$1.9 million.

Third quarter 1993: Confederation announces that it needs financial help.

December 1993: Great-West undertakes to work out a deal to save or absorb the company, and begins a review of Confederation's books to further evaluate the situation.

23 July 1994: Major Canadian life insurers band together to attempt a joint rescue of Confederation with a \$600 million loan, but talks stall.

11 August 1994: Federal officials, fearing that public apprehension will lead to a surge in withdrawals and cancellations, decide to shut down Confederation.

Lessons to be Learned

Set limits and establish a balance

The concentration of 71 percent of the company's assets in real estate was a major factor in the company's dissolution. It does not appear that the company planned any strategy for diversifying or otherwise limiting its risk in the real estate market.

Apply checks and balances on the activities of those in positions of power

The Chairman's determination to concentrate vast amounts of assets in real estate went virtually unopposed. Michael Mackenzie, Canada's former superintendent of financial institutions, provides insight into the danger this poses:

"I have been trying to train people that this is an early warning sign of trouble anywhere, it doesn't matter what the company, what the industry: When you see a CEO, a strong-minded CEO, who brooks no opposition inside, watch out. . . If he doesn't create an open working atmosphere where people can say, 'Pat, for Christ's sake, this doesn't make any sense,' [the company courts disaster] because if they're not going to say it at the operating level, they're also not going to say it at the board level." (The Globe and Mail, 12/22/94).

Understand the business:

The cyclical nature of the real estate industry was apparently completely ignored. Mortgages were given out indiscriminately to some borrowers who probably would not have qualified under a normal application process.