

Report of the 11th A2ii – IAIS Consultation Call

Risk-based Supervision in Inclusive Insurance

23 July 2015



The A2ii consultation calls are organised in partnership with the IAIS to offer a platform for supervisors to exchange experiences and lessons learnt in expanding access to insurance.

The 11th consultation call, held on 23 July 2015, was focused on risk-based supervision (RBS) in inclusive insurance. The calls were hosted by Hannah Grant (A2ii) in English, Onur Azcan (A2ii) in French and Patricia Inga Falcon (A2ii) in Spanish and supported by George Brady and Jules Gribbles from the IAIS Secretariat. Technical inputs were provided by **Holly Bakke** (Financial Systems Expert, Strategic Initiatives Management Group, LLC) on the English calls, **Louise Adnot** (Autorité de contrôle prudentiel et de résolution, ACPR, France) on the French call and **Dr. Ian Web** (Technical Specialist, Prudential Regulation Authority, Bank of England) on the Spanish call. Country experiences were presented by **Rinald Guri, PhD** (Head of Research, IT & Statistics Department, Albanian Financial Supervisory Authority (AFSA)) and **Jocelyne Kaneza** (Agence de Régulation et de Contrôle des Assurances, ARCA, Burundi). On the call an overview of the key considerations for implementing a risk-based supervision (RBS) framework was provided, and supervisors were given the opportunity to discuss the challenges in implementing RBS in their respective jurisdictions.

Considerations for prudential supervision in inclusive insurance markets

Prudential supervision should be both risk-based, and proportionate. These criteria are equally relevant when supervising insurers who are operating in conventional insurance markets, as well as in inclusive insurance markets. However, as there are differences in the nature, size and risk profiles of the insurers involved, and the business lines written; prudential supervisory approaches applied to conventional markets may not be appropriate for inclusive insurance. Therefore, a risk-based supervisory framework should, if proportionately applied, take into account the following considerations:

- Nature of the insurer's business;
- Risks arising from that business;
- Steps taken by the insurer to mitigate risks;
- Likelihood of risks being realised in spite of mitigation; and
- The potential impact if those risks are realised.

For instance, when assessing the risk of a large complex insurer, or an insurer with complex products, sophisticated risk management methodologies might be appropriate. Likewise, such an insurer should be expected to employ sophisticated risk management practices. Conversely, if there are many small insurers with simple risk profiles, or an insurer with a business line that has a lower risk, a proportionate risk-based approach to supervision might be best.

Whatever the approach, it is important for supervisors to remember not to assume that small insurers, small policies, and low risks, always go hand in hand. Whenever higher risks are identified, both the insurer and the supervisor should move towards more sophisticated risk assessment; but where low or lower risks are present, supervisors should allow for simpler risk assessment and risk management practices.

Application of risk-based supervision in inclusive insurance markets

As insurance is designed to manage risk, the risks associated with any product must be identified, and when possible mitigated, if the dual goals of regulation - consumer protection and financial stability - are to be met. Risk Based Supervision (RBS) is a tool to help regulators satisfy those requirements. The first step to implement risk-based supervision (RBS) is for supervisors to review their current supervisory approaches, so as to determine whether a differentiated approach - one that is tailored to the type of business and/or the type of insurers - should be taken to better manage risks in the market.

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A risk-based supervision framework is a structured process aimed at identifying the most critical risks that face each insurance company and, through focused review by the supervisor, assessing the company's management of risks, and the company's financial vulnerability to potential adverse experience.¹

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Current supervisory frameworks adopted by insurance supervisors can be categorised into three broad approaches. The first approach is Solvency I, in which supervisors adopt a formulaic approach to calculate the minimum capital requirements applied to all insurers. A second approach incorporates simple risk factors into the solvency framework, although this approach often remains formulaic and rigid. The third approach, RBS, sets minimum capital requirements based on a comprehensive set of quantitative and qualitative factors. For example, corporate governance is an important risk factor to consider within an RBS framework, yet it is not easy to quantify and requires subjective judgement on the part of the insurer and the supervisor.

While the application of the first two supervisory approaches requires very little input from insurers, the application of RBS requires that insurers play a more active role in risk assessment and risk management. For instance, insurers may need to conduct actuarial assessments, internal and external audits, as well as provide detailed reporting to the regulator on key business activities and internal risk management practices. Therefore, the availability of resources, capacity, and skills within the market is a key consideration for the application of RBS. For further guidance the World Bank developed a [RBS regulatory readiness assessment](#) to be used by supervisors to assess their readiness, as well as the readiness of insurers operating in their market.

Proportionality is another important consideration for the application of RBS, especially in markets dominated by small insurers or microinsurers and insurance products with lower risk profiles.

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The principle of proportionality requires that supervisors assess compliance with a regulatory framework in a manner proportionate to the nature, scale and complexity of the risks inherent in the business of insurers.

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An area where proportionality will be essential is in the requirement for [actuarial services](#). Supervisors may need to vary the requirement for actuaries and actuarial assessments, depending on the available resources and skills in the market. For large insurers and complex products, one can expect that an actuary will be employed in some capacity and to some extent to price products, calculate technical provisions and help the

¹ [Risk Based Supervision of the Insurance Companies, an Introduction \(2001\)](#). Prepared by John Thompson for the World Bank.

insurer manage mitigate risks related to those products. However, for smaller insurers, this is not likely to be the case. Therefore, providing alternative mechanisms for smaller insurers and microinsurers to assess and manage risk will be important to ensure RBS does not inhibit market development and financial inclusion in insurance markets.

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A risk-based supervision framework is a partnership between insurers and the insurance supervisor.

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Importantly, there is no “one-size-fits-all” approach for the application of RBS. Each supervisor will need to take into account the characteristics of its market, including existing regulations, and balance the need for resources, with the available skills and capacity. The key questions to consider when developing an RBS framework that works for inclusive insurance markets include the following:

- **What risks – to insurers, customers, or supervisory objectives – are posed by a particular situation?**
- **What are the likelihoods of risk being realised, and consequences if realised?**
- **What alternatives are there?**
- **What are the costs and benefits of each alternative?**
- **Which alternative offers lowest cost while mitigating risks?**

With these questions in mind, supervisors can develop and apply an RBS framework that is proportionate, that takes into account existing resource constraints and challenges, yet ensures that solvency and consumer protection risks are better identified and managed.

Country experiences with risk-based supervision

The approach taken by the Financial Services Authority (FSA) in Albania, and the Insurance Regulatory and Supervisory Agency (ARCA) in Burundi, provide insight into progress that can be made in applying RBS at different stages of market and regulatory development.

Case study: Albanian Financial Services Authority

The Albanian Financial Services Authority (AFSA) in collaboration with the World Bank developed an RBS methodology in 2010, which was adopted in 2014. A key output of this new methodology has been a risk-focused supervision manual, which is used to implement the RBS framework.

To help the industry comply with the new RBS framework, which includes requirements for qualified professionals and supporting market infrastructure, the AFSA undertook a number of initiatives to build capacity in the market:

The risk assessment matrix provides for the assessment of **business risk in the individual activities** engaged by insurers, rather than the risk of the institution as a whole. The key business activities are identified in the same structure that the insurance company manages its operations. The matrix therefore provides a means to measure the composite risk, or institutional risk profile of insurers in the market, and allows the AFSA to look at insurers in the same way they look at themselves. Importantly, **all the risks included in the matrix are subjective**, and no figures or formulas are used to arrive at the composite risk. This provides AFSA with more flexibility and subjectivity, making the need for good quality documentation imperative.

The feedback, so far, has been positive, although insurance companies are facing challenges in complying with the new framework. It has changed the way AFSA is looking at companies and the risks in the market. In addition, applying proportionality has not been easy, but the AFSA has adopted a flexible methodology, to assist in addressing these challenges. The AFSA is of the view that corporate governance and risk management are the main drivers of market development and stability. In addition, the AFSA is committed to ensuring continuous capacity building for this new approach.

Burundi Case Study

Burundi has a relatively new insurance market, with only 6 insurers operating and the market dominated by car insurance products. The Insurance Regulatory and Supervisory Agency (ARCA) was operationalised in 2011, and equipped with technical staff in 2013. In 2014, revisions were made to the legal and regulatory framework. However, challenges remain in the areas of risk management and governance, data collection, and actuarial expertise.

ARCA is in the early stages of implementing Solvency I, and has already started introducing some measures of risk and proportionality into the supervisory framework. Although the ARCA's focus remains largely on calculations and formulas under Solvency I, the agency is also assessing **corporate governance**, and the **strength of auditors** in insurance companies. The ARCA is also considering creative ways to address the lack of actuaries in the market – including allowing companies that are small and write less complex risks to contract an actuary once or twice a year to conduct risk assessments or, allowing other actuaries in East Africa to provide actuarial services on a more routine basis when needed rather than requiring them to have in house actuaries.

Other initiatives undertaken by the ARCA include:

- Memorandum of Understanding (MoU) with East African Insurance Supervisors Association (EAISA) was signed for **cross-border supervision**. The MoU highlights EAISA's objectives to:
 - provide mutual cooperation and exchange of information for Supervisory purposes;
 - maintain and promote a stable, efficient, fair and safe insurance market in the region with a view to contribute to financial stability;
 - promote adequate protection of policyholders and to ensure conducive regulatory environment for stakeholders
- **A manual for cross-border supervision** and the supervision of insurance groups was developed.

Overall, the country experiences show that while there may be challenges in introducing and implementing the RBS, supervisors can develop and apply the RBS framework in a manner that takes into account existing capacity constraints and resource challenges in their respective markets.

Importantly, supervisors will need to promote opportunities for capacity building and engagement with insurers in the market to ensure the RBS is implemented proportionately, and effectively.

Questions and discussion

The discussion by participants on the call was focused on other country's experiences with implementing RBS. The following questions and comments were made:

? *How difficult is it to implement a RBS system?* The technical experts on the call indicated that the application of RBS should take into account the resources and level of expertise available in the market. This includes providers and supervisors. With adequate training, insurance providers can comply with new RBS requirements, if they are applied in a proportionate manner. However, proportionality also covers assessing the regulators capacity to implement RBS, and designing the supervisory approach in line with available regulatory capacity and resources. It should also be considered that RBS is not an off-the shelf product, but rather can be introduced with varying levels of sophistication and reliance on third parties.

? *How can regulators embed AML/CFT² elements in the RBS approach?* AML/CFT is a key component of RBS in inclusive insurance markets. In some jurisdictions, the implementation of the risk-based system involves AML/CFT stakeholders, such as the Fraud Unit. Money laundering and terrorist financing risk can also pose solvency and consumer protection risks in the insurance market. Assessing corporate governance and sources of funding from an AML/CFT point of view can provide insight into risks in the insurance market. It is therefore important to ensure coordination and cooperation between the supervisor looking into AML/CFT and insurance regulation as well as other regulatory bodies.

? *How should supervisors align documentation, data requirements, cost efficiency, and implementation of RBS with respect to inclusive insurance?* Applying proportionality to the implementation process for RBS is key; and implementation should be introduced gradually. A full blown RBS system will require significant reporting. However, in inclusive insurance markets, with simple insurance products where limited information is collected from insurance clients, there will be less reporting to provide to the regulator. Regulators can therefore focus on assessing other areas of risk through less, but more focused, documentation from smaller insurers and microinsurers.

? *How should supervisors apply a risk-based approach to companies that provide both traditional insurance products and microinsurance products?* A substantial share of microinsurance products are delivered by an established insurer as an additional business line or product, rather than by smaller or specialised microinsurers. This often reduces the overall risk inherent in the microinsurance activity, as the risk in these microinsurance lines are often offset by established lines of business in the insurer's portfolio. An established insurer offering other types of insurance products will also often have

² Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT).

actuarial, risk management and governance capacity to call upon to help manage the microinsurance activity. The supervisor can assess to what extent the above is true for each insurer offering microinsurance, and vary its supervisory approach accordingly. A risk-based approach will dictate that a supervisor consider the risk generated by a microinsurance line of business, the extent to which this risk is adequately measured, monitored and managed by the insurer as well as any third parties upon which the insurer relies upon for independent assessment, and then based on this determine the type of supervisory monitoring and review required.

? How should supervisors fill out the RBS assessment matrix ³for a company that provides both traditional and microinsurance products? An RBS matrix is typically designed so it can capture the inherent and net risks associated with an insurer's various key activities. For an insurer with microinsurance and traditional insurance products, microinsurance will be treated as other key business activities, with the assessment summing up the overall impact of net risks on key firm indicators (e.g. capital and earnings). With respect to microinsurance, it is important to consider the risks that are intrinsic to that type of activity and the challenges they pose for the insurer, the quality of oversight and risk mitigation the insurer brings to bear, and the overall impact that unexpected results arising from this activity can have on the insurer.

Philippines experience with implementing RBS

The Risk Based Capital Framework (RBC)/RBS has been in place in the Philippines since 2006, the year that the Insurance Commission issued the pertinent circular letter. In 2013 the insurance code in the Philippines was amended. Prior to the amendments, the code included statutory requirements to look at the financials of a company in terms of solvency, capital and net worth. Under the amended code, lawmakers have encouraged the Insurance Commission to implement risk based capital supervision in order to harmonise with the new trends on Financial Reporting Standards. The Commission has started by working closely with the industry to improve on the current RBS system (RBC1). This work is occurring in parallel with reporting also continuing under the old system i.e. companies are being asked to compute their risk based capital requirements based on RBC1, as well as on the proposed new risk based capital system (RBC2). RBC2 reclassifies the risk factors to be considered from 4 risk factors under RBC1 (Credit, Insurance Pricing, Interest and General Business Risks) to 6 risk factors under RBC2 (Credit, Insurance Liability, Market, Operational, Catastrophe and Surrender Risks⁴). RBC2 is also considering re-calibrating the risk weights/charges of the various factors that affect the capital of an insurance company. Corporate governance has also been incorporated in the risk assessment under the new system. However, the major challenge in the Philippines market is the cost of compliance with the proposed RBC2 for non-life companies⁵, which is mainly a result of the need for actuarial services. The Commission has started to address these issues by coordinating with the Actuarial Society of the Philippines to implement a programme to build capacity for actuaries and auditors, both for the Commission and the insurers in the market.

³ Please find an example for a RBS assessment matrix in annex 1.

⁴ Only for life companies

⁵ Life companies have always been required to have an actuary from the very beginning of their respective business operation

Kenya's experience with implementing RBS

The supervision framework for the Kenyan insurance industry has shifted from compliance based supervision to RBS. Under the RBS framework, three key components are involved; quantitative requirements, qualitative requirements and supervision and disclosure requirements. The implementation of these three components began in 2013.

» 1. Qualitative requirements

A standard risk based capital model has been developed that will be used to capitalise insurance companies. Going forward, companies could be permitted to use their own internal model.

» 2. Qualitative requirements and supervision

Insurers are required to have four corporate governance functions. When this requirement was rolled out in 2013, there were few qualified or nearly qualified actuaries. However, the number of actuaries has greatly increased through a sponsorship program that the Kenyan Insurance Regulatory Authority (IRA) established to send five actuarial students to Cass Business School, London. So far, 20 student actuaries have benefited from the program.

An Onsite Inspection Module has also been developed through which supervision officers will assess the risk profile of insurers. This module contains a set of assessment questions and a risk scoring system is used to obtain an indicative risk rating. Going forward, insurers will be required to perform an Own Risk and Solvency Assessment.

» 3. Disclosure

The IRA has developed an Electronic Regulatory System which provides a platform for the implementation of RBS. Quantitative reporting templates are submitted on a monthly, quarterly and annual basis. Appointed actuaries are also required to submit a Financial Condition Report on an annual basis.

Annex 1: RBS regulatory readiness assessment

Source: *Risk Based Supervision of the Insurance Companies, an Introduction (2001)*, prepared by John Thompson for the World Bank.

Indicator	Supervisory Model			
	Controlled	Limited Reliance	Partial Reliance	Full Reliance
Actuaries: - number	More companies than actuaries	Large companies have their own actuaries	Most companies have their own actuaries	Companies all have well qualified actuaries
Actuaries - qualifications	Regulator decides who can act as the company actuary	Qualifications set by the professional association	Code of conduct enforced by the profession	Actuaries are responsible and held accountable for their own work
Actuaries - standards of professional practice	Set by the regulator	Most aspects are defined by the profession	Fully defined by the profession but a wide range of choice is available, limited discipline	Fully defined with a narrow range of choice and enforced discipline to use standards
Accountants - number	More companies than accountants	Large companies have their own accountants	Most companies have their own accountants	Companies have well qualified accountants
Accountants - qualifications	Regulator decides on who can act as the company's accountant	Qualifications set by the profession	Code of Conduct enforced by the profession	Accountants are responsible and held accountable for their work
Accountants - standards of professional practice	Set by the Regulator	Most aspects are defined by the profession	Fully defined by the profession but a wide range of practice is possible, limited professional discipline	Fully defined by the profession and a narrow range of choice is available, tight discipline and enforcement

Auditors - number regularly	Few available to do the work and remain independent	Few but strong recruiting and training of new auditors	Sufficient to allow choice but limited flexibility to change auditor	Sufficient to allow lots of choice and flexibility to change auditor
Auditors - qualifications	Regulator decides who can act as the company auditor	Qualifications set by the professional association	Code of conduct enforced by the profession	Auditors are responsible and held accountable for their own work
Auditors - standards of professional practice	Set by the Regulator	Most aspects are defined by the profession	Fully defined by the profession but a wide range of practice is possible, limited professional discipline	Fully defined by the profession and a narrow range of choice is available, tight discipline and enforcement
Industry Associations	Primarily focused on lobbying for the industry	Set selected standards of behavior for companies to follow	Comprehensive standards but weak enforcement powers	Comprehensive standards with strong enforcement and discipline powers
No-executive members of the Boards of Directors	Few independent directors required	Independent directors are required but have no special role	Independent directors have role in selected committees of the board	Independent directors have clear responsibility and accountability
Ownership of financial institutions	Primarily closely held domestic institutions	Big domestic institutions are widely held. All are publicly owned	Most domestic institutions are widely held and internationally active	All domestic institutions are widely held

Corporate Governance for companies	Weak internal controls and compliance assessment process	Company policy required in selected areas	Comprehensive range of company policies are required	Comprehensive range of policies with close monitoring and remedial programs in companies
Judiciary System	Inconsistent or untried interpretations	Weak public confidence in the fairness of the courts	Strong public confidence in the courts	Strong public confidence and the courts have experience in interpreting financial sector legislation
Liquidation legislation	No clear legislation to deal with insolvent financial services providers	Weak and untested legislation to deal with liquidations of financial services companies	Untested but strong legislation to deal with financial services liquidations	Legislation to handle liquidations is strong and has been tested to be effective
Policyholder Protection arrangements	There is none	One exists but it is not understood or widely known	One exists but its readiness and effectiveness is questioned	One exists and its readiness and effectiveness is understood
Banking system - Personal	Some personal savings is held in banks, public confidence is weak	Most personal savings are in banks	Personal savings is in banks and confidence is strong	Personal savings are in variety of regulated and unregulated financial products
Banking system - corporate	Small and weak domestic activity	Small but the primary sources of commercial lending	Large and the primary sources of commercial lending	Commercial lending is performed by a variety of regulated and unregulated entities
Banking system - Investment	Small and weak domestic activity			Major activity for banks

Capital Markets system	Low market capitalization and low market activity	Modest capital market, but not seen as the primary source of financing	Large capital market but banks and insurers dominate financing	Active capital markets and primary source of financing for listed companies
Supervision - political influence	Most significant decisions require approval of elected officials	Most significant decisions are made by the supervisor but funding is a part of the government budget system	Supervisory agency can make independent supervisory decisions but its budget is linked to government budgets	Supervisory agency is independent to make decisions and is funded separate from other government activities
Supervision - corporate governance of the agency	Supervisory role is a part of a government department	Supervisory agency is separate from other government departments		Supervisory agency is independent of government and has a board
Supervision - product control	Supervisor sets or approves product design and pricing	Products are filed with the supervisory and some terms and conditions are prescribed	Products are filed with the supervisor	Companies are free to design and price products freely without notice or filing
Supervision - process for valuing assets	Supervisor sets or approves values assigned to asset	Some asset values are set by GAAP but most are prescribed	Value of assets are for the most part set by GAAP and some are set by regulation	Value of assets are determined using GAAP
Supervision - process for valuing liabilities	Supervisor sets the methods and assumptions for valuing liabilities	Assumptions and methods vary from the prescribed model to reflect company differences with the approval of the supervisor	Assumptions and methods reflect differences in company risk exposures but are approved by the supervisor	Methods and assumptions for valuing assets are set by the standards of practice for actuaries

Supervision - required capital approach	Supervisor sets an easy to apply and easy to test required capital formula	Comprehensive capital model that varies by category of asset and liability	Simplified risk based capital model with broad risk categories	Dynamic risk based capital model that reflects different net risk exposures
Supervision - analysis and on-site approach	Supervisor carries out an audit to ensure that companies follow the legislated and other rules	Supervisor carries out sample based audit and tests at a detail level certain areas of risk	Supervisory process is built on a risk based analysis and on-site model	Focus of the supervisory process in on testing the confidence that the supervisor has on relying on the work of others



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