



**Insurance Law and Regulation Conference hosted by Lloyd's**

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**International Developments in Insurance Supervision**

Good morning,

I would like to thank Lloyd's for organizing this conference. I am honoured to join this distinguished panel in discussing current developments in insurance law and regulation, and more particularly insurance supervision.

The IAIS is recognised internationally as the standard setting body of insurance supervision and has grown significantly over recent years. Its input is sought not only by insurance supervisors in developed and developing markets, but also by other financial sector regulators, professional bodies and international associations. Today, insurance supervisors are faced with many challenges including globalisation, economic uncertainty, climate change, development of new markets and financial innovation to name a few. These all reinforce the need for supervisors to cooperate to develop consistent standards and reach out to emerging markets.

Since 1994 the IAIS has embarked on the development of an agreed international framework for insurance supervision in close cooperation with other financial sector standard-setting bodies and international organisations. It advances global principles, standards and guidance papers that aim at improving consistency of policy holder treatment and market consistency across jurisdictions. Together principles, standards and guidance papers set out a high-level framework for insurance supervision. The proposed principles and standards are forward looking and embrace ongoing developments while staying general and practical. In this way, the IAIS aims to help its members to cope with the difficult issues of cross-border and cross-sector business, risk-taking and innovation.

**1. Global approach of the IAIS**

As a global organization, the IAIS has adopted an approach that allows taking into account the realities of today's financial markets. The insurance industry is in the midst of a radical transition from acting with a domestic focus to doing business in a global marketplace. Emerging markets are developing with an increasing speed, building their infrastructure and opening their markets to foreign players. This increasing globalization brings us to a situation in which insurance supervisors cannot carry out their own jurisdictional mandate without cooperation with regulators in other jurisdictions or other parts of the world. Close cooperation between regulators is therefore essential to each supervisor and the industry as a whole. In this view, the main goals of the IAIS are also in the interest

of the insurance industry, i.e. the development of sound insurance markets, policy holder protection and global financial stability.

While the traditional domestic focus should not be forgotten the strategy shift towards a global perspective now forms the real challenge for insurance companies and supervisors. Insurance supervisors need to adapt their regulatory framework from a national perspective to a more global one. The objective is to find the right balance between the evolving national requirements and emerging regulatory developments at the international level. The IAIS framework for insurance supervision does not imply a single, uniform approach to supervision. There is not a single answer to the challenge of designing a modern supervisory regime for insurers. But it is nevertheless important that similar elements are treated fairly and consistently amongst jurisdictions, with respect for local characteristics.

Global convergence towards a generally-accepted, improved standard of supervisory practice is a long-term goal toward which the IAIS, as an international standard-setter, must aspire. The IAIS sees the potential for an improvement in the level of supervisory standards and increased convergence towards these standards over time. In the longer term, as greater convergence of practice emerges, greater acceptance of supervisory standards between jurisdictions should be achieved. However, the challenges of achieving such an environment are not to be underestimated, and the expectations in terms of timeframes for reaching such an ultimate goal must be realistic. Therefore, it is important that a focus on this long-term goal underlies the current policy directions and steers the standard-setting activities of the IAIS, while facilitating interim steps.

## **2. Scope and methods for action**

Traditionally, two different methods for supervisory action can be delineated, i.e. rules-based supervision, often called the 'box-ticking approach', and the principles-based approach. While some jurisdictions such as the UK are particularly acquainted with a principles-based approach, it entails a new approach to supervision for many other jurisdictions around the globe. In order to cope with a globalizing environment, the IAIS has assumed its responsibilities and has, as a global standard setter, allowed for evolution from a box-ticking approach to a principles-based approach. Accordingly, several efforts are being undertaken to educate and convince the IAIS members of this alternative approach to supervisory action.

Principles-based regulation means moving away from detailed prescriptive rules and supervisory actions towards placing a greater reliance on broad-based standards and outcome-focused high level rules. Past experience has shown that prescriptive rules are difficult to adapt to fast changing markets and often not effective to prevent misconduct. A rules-based approach tends to stimulate creative ways to deal with the rules, to find loop-holes in the rules or to circumvent the rules. This often results in 'formal compliance' with the prescribed rules, rather than effective management and change of the business.

In a principles-based regulatory regime, insurers have responsibility for ensuring how best to align their business objectives and processes within the specified regulatory outcomes. Regulations that focus on outcomes rather than prescriptive rules are more robust and better able to support innovation and product development and adapt to changes in the financial landscape. Principles-based standards allow flexibility to respond effectively to different types of market circumstances. In line with technological and scientific progression, IAIS standards and practice are now strongly based on a risk approach to supervision. The solvency, valuation and risk management standards now require the full use of available modelling techniques and envisage further development in meeting future challenges as needed.

Clearly, principles-based regulation presents a number of challenges for both insurance companies and supervisors. For insurers, it implies a shift in focus from managing a legally driven compliance

process with detailed rules to managing the delivery of defined outcomes with fewer certainties about what processes need to be in place. As a result, greater responsibility is put on executive management which needs to ensure that processes and controls are suitable for the business being undertaken and the specified regulatory outcomes are met. In meeting these challenges outcomes must be carefully monitored and processes increasingly require the exercise of professional judgement as provided by transversal organisational functions such as risk management, internal audit and compliance.

For supervisors, a principles-based approach involves a change in the extent and line of supervisory work undertaken. Instead of merely checking compliance with rules, supervisors need to exercise judgement in assessing organisational processes and controls in relation to the size and complexity of the business. Supervisory staff needs to understand complex issues and keep up to date with constantly changing markets and continuous innovation. In many instances, this requires an enlargement of the workforce and a further expansion of the knowledge, skills and capabilities in place.

### **3. Need for tighten up of the standard-setting activities**

During the last year and a half, ongoing changes in the marketplace have urged the need for a tighten up of the standard-setting activities resulting in a strategic prioritization of the IAIS objectives by the Executive Committee. In line with the medium and longer term strategic direction, a roadmap for standard-setting and a roadmap for standard implementation activities have been drafted and thoroughly discussed by the Executive Committee of the IAIS in order to establish the building blocks for longer term progress.

The Roadmap for Standard Setting sets out the policy direction and priorities for all IAIS standard-setting activities within the Framework for Insurance Supervision. Promoting the development of a comprehensive and coherent set of supervisory papers is an essential element in facilitating greater convergence of supervisory practice. In this work, an appropriate balance is sought between the development of principles-based standards, which provide necessary flexibility for a diverse sector, and the provision of adequate supporting guidance material to facilitate necessary consistency of interpretation.

The Roadmap for Standard Implementation Activities sets out a series of implementation activities to encourage a practical application of IAIS principles and standards. These activities seek to enhance the understanding of IAIS principles and standards amongst its members and to support the strengthening of the institutional capabilities of supervisors for the adoption of these standards. Essentially, the exchange of experiences and skills among IAIS members is facilitated and supervisors are supported in understanding particular topics linked to specific regulation issues that are relevant for the regions. In this respect, several work streams have been set up as further illustrated in some key IAIS activities.

#### **4. Current IAIS key activities**

As a global standard setter, the IAIS needs to keep pace of ongoing developments in the industry and supervisory sector. Recent developments, particularly in solvency, governance and group-wide supervision have become an important area for attention. In relation to this, the globalisation and increasing integration of financial markets have created new demands for supervisors such as more extended international supervisory cooperation and recognition. The IAIS tackles these and other emerging demands through its different work streams uniting supervisors from around the globe.

##### *Review of Insurance Core Principles*

Evolving practices in industry have made it necessary to again take stock of the Insurance Core Principles (ICPs) to ensure they remain relevant, comprehensive and current. Recently, a review of the foundation principles has begun with the goal to present revised core principles and methodology at the IAIS General Meeting in 2008. Consistent with all IAIS supervisory papers, the ICP review will include dialogue with IAIS members and the industry while incorporating observations and comments from the IMF and the World Bank. In their Financial Sector Assessment Programme (FSAP) the IMF and the World Bank regard the implementation of the core principles developed by the IAIS, the Basel Committee and the IOSCO a prerequisite for an effective supervisory regime.

##### *Developments on solvency and risk management*

The incessant growth of cross-border and cross-sector active financial institutions requires the use of consistent, reliable and transparent methodologies for measuring and assessing solvency. Needless to say, this is a key element to ensuring financial stability and enhancing market confidence in the insurance sector. A number of initiatives are being undertaken by our members and observers to develop together a cohesive set of supervisory standards on insurer solvency embracing a wide range of both quantitative and qualitative aspects of solvency assessment. The first three of five formal solvency standards and guidance papers are expected to be adopted at the AGM in October.

As shown in the recent turmoil, there is room for further progression of the current systems of risk management and econometric modelling. Within these developments, it is important that new technologies and statistical models are rooted in the real world and continue to be severely scrutinized in a wide range of circumstances. Next to this, expert opinion stays of central importance to ensure that the explicit and implicit limitations of new systems are acknowledged and analysed. Regulators and supervisors along with the financial companies have to remain vigilant at all times that the proposed models and techniques are sound and that these are used correctly. For instance, they need to ensure that the models' limitations are respected and the obtained results are used in the right context and constantly updated.

##### *Work on group-wide supervision*

Given the economic reality of how financial groups today operate in a global insurance market the IAIS has identified the work on group-wide supervision as an area of high priority. The globalisation of financial institutions and the expansion of their operations into multiple financial sectors clearly pose a number of challenges to the organisation and implementation of group-wide supervision, as regulatory responses often are characterised by a lack of both consistency and comprehensiveness. The development of regulatory requirements and supervisory practices in respect of group-wide and cross-sector supervision is a complex area with many interrelationships and dependencies to be considered. In this area, the IAIS has due regard for the work in study fora such as the Joint Forum.

Current work on group-wide supervision is closely coordinated with other standard development work, for instance in respect of the developments of capital adequacy and solvency assessment, and reinsurance supervision. At present, a principles paper on group-wide supervision has been developed establishing an internationally acceptable framework of supervision on a group-wide basis, and which is expected to be finalized later this year. Next to this, a guidance paper on the role of a group supervisor and an issues paper on solvency assessment for groups are being developed. Following these papers, and informed by the exploratory work in the issues paper, consideration will move to the development of a standard and guidance on group capital adequacy.

#### *International supervisory cooperation and mutual recognition*

In this globalizing environment, the IAIS is alert and responsive to ongoing regulatory developments occurring at national and international levels. In February 2007, a Multilateral Memorandum of Understanding (MMOU) for the sharing of information between supervisors was adopted. This framework establishes a formal basis for facilitating cross border communication and the exchange of information between supervisors on the supervision of insurance companies and groups. The current interest of diverse members in applying for MMOU accession can be seen as an important step towards broadening contacts and creating mutual trust and confidence amongst insurance supervisors on a global level.

Currently, the lack of mutual recognition among supervisors creates barriers to growth in reinsurance and additional costs in terms of capital and complying with different supervisory frameworks. There are a number of readily identifiable benefits associated with an effective system of mutual recognition from facilitating market access to enhancing market efficiency. An effective system of mutual recognition would give rise to a greater degree of reliance placed on home/host supervisors by each other which would in turn reduce duplication of efforts. The IAIS is striving to facilitate the development of a sound global reinsurance market by fostering the development of a framework that should be sufficient to allow supervisors to mutually recognise the quality of the regulation and supervision exercised by one another in their respective jurisdictions.

In this respect, the proposed policy directions in the US with the Blueprint for modernizing the financial regulatory structure offer opportunities for a further broadening of the important discussion of mutual

recognition between supervisors, which eventually could result in the creation of a one-stop-shop for companies in the US and the EU.

#### *Addressing the emerging markets*

As a further response to increasing globalisation, the IAIS is addressing the unique requirements of emerging markets. The emerging markets of today can be considered as the welfare drivers in a hopefully not too distant future. The IAIS fully supports insurers to provide the low income population with increased access to insurance and to allow microinsurers to evolve within the formal insurance sector. Through training, technical assistance and institutional capabilities building, the IAIS seeks to enhance efforts of its members to implement standards and effectively incorporate them to local legal frameworks. As a part of its efforts to reach out to emerging markets, the IAIS has launched a comprehensive education project for insurance supervisors. The project will supplement IAIS seminars to reach a much broader audience and will be supported by voluntary contributions from members and observers. The existing Core Curriculum material of the IAIS and the World Bank will be further developed into online interactive courses supplemented with workshops and distance learning events.

#### *Activities relating to financial stability*

As a possible downside to the increasing globalisation, the IAIS needs to be alert to financial stability threats and improve its responsiveness to rapidly changing situations. Last year, a Financial Stability Task Force was installed with the primary aim of conveying the IAIS's views to the Financial Stability Forum (FSF) on issues which matter to the insurance sector in view of global financial stability. In the light of the recent financial turmoil, the Task Force is working on constructive actions to address some of the problems that have recently emerged. The Task Force prefigures what will become a Public Policy Strategy Group within the Executive Committee, i.e. a standing think tank for public interest questions.

The experience of the last months has shown that an in-depth comparison of banking and insurance regulatory approaches would provide valuable regulatory insight. The IAIS is considering learning from potential deficiencies in the regulatory framework of the banking sector including the cooperation between regulators and supervisors in times of crisis. Regulatory arbitrage between the banking and insurance sectors, for example, for structured credit products should be avoided. Indeed, currently, bond insurers are subject to prudential requirements similar to those of other insurance entities while their activities are economically much more comparable with banking activities than with insurance business. Further work on regulatory and supervisory requirements for credit insurance type products will be considered in close cooperation with the banking regulators and supervisors, so that similar risks are addressed by similar regulation and regulatory arbitrage is avoided.

#### *Contributing to accounting developments*

For effective action and reaction to emerging threats and opportunities, the IAIS bears on a close cooperation with its sister organisations and other standard-setters. For instance, the IAIS actively monitors and provides input to the International Accounting Standards Board (IASB) projects. Current market events have placed market-based valuation under pressure, particularly when market prices are no longer observable, or the market becomes thin. Moving from a situation of observable inputs to a so-called “mark to model” system is likely to require further work on modelling and present greater challenges to preparers of accounts and auditors. The different time horizons of insurance and banking products can pose various challenges for asset liability management in the two sectors. The IAIS is providing input to the IASB in its work on fair value measurements, and is contributing to work in this area by the international auditing standard-setter.

### **5. Some final words to conclude**

Under its principles-based approach, the IAIS is committed to intensive cooperation and dialogue between members and observers. It has a long standing tradition of respect of the particularities of its members and seeks to promote appropriate convergence through training and education. The observer membership category has facilitated enhanced cooperation between insurance supervisors and the industry which is necessary to any standard setting body. Observers participate in the consultation process and provide valuable comments preceding the adoption of IAIS papers. The hearings at our tri-annual meetings provide the opportunity for industry discussion on technical issues.

In this way, the IAIS has been able to adapt to the actual structure of the financial markets.

Thank you.