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TORONTOCENTRE
Global Leadership in Financial Supervision

Regulation and Supervision Supporting Inclusive Insurance Markets – Prudential Issues

Inclusive Insurance Regional Training Program for Insurance Supervisors
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D. Prudential issues

1. Licensing
   a. Licensing of entities and pilots
   b. Implementation formalization and transitional arrangements
2. Operations
3. Solvency regime
4. Supervision

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Licensing

Importance of licensing

- Define conditions for access to the market
- Limit access to those meeting the conditions
- Balance is essential
  - Weak requirements can expose customers to excessive risk
  - Onerous requirements can reduce their access to insurance

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Regulated insurance activities

- Broad scope is generally better
- Avoid exempting insurance from regulation
- Avoid restricting desirable insurance activities

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Eligibility for licensing

- Wide range enhances access
  - Accommodate current or future MCCOs
- Avoid exemptions unless appropriate alternative protections
- Avoid restrictions unless they support supervisory objectives
  - Institutional form
  - Domicile of entity or owners
  - Nature of owners
  - Specialization
- License should be aligned with capabilities

Types of providers

- Traditional insurers
- Dedicated microinsurers
- Mutuals, cooperatives and community-based organizations – MCCOs
- MFIs and other financial institutions

- For-profit or not-for-profit
- State-owned
- Public-private partnerships

- Current legal status
  - Regulated under insurance law
  - Regulated under another law
  - Informal and unregulated

Dedicated licenses

- Some jurisdictions offer a special license for “dedicated microinsurers” or “specialist microinsurance intermediaries”
  - More focused scope of licenses
  - Some additional tasks possible, not only reducing obligations
  - Proportionate requirements (not concessional compared to risk) with limits

Mixed entities

- Protect policyholders from risks of non-insurance businesses
  - Require separate legal entity to underwrite insurance
  - Transitional arrangements might be needed
- Ability to package life and non-life insurances enhances access
  - Composite insurers
  - Products that all insurers can underwrite
  - Perhaps limited to microinsurance

Small entities

- Some entities are too small to be licensed
  - Technical – risk pooling
  - Operational – business processes
- How can you determine the minimum size?
  - Stochastic modeling
  - Business financial modeling
  - Benchmark locally and with other jurisdictions
  - Consult with market participants

Pilot schemes

- Used to test an approach and learn what modifications are needed
  - If regulated insurance activities are involved, customers should be protected
- Might be used by licensed insurers or other entities

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Use of pilots

Use of pilots by licensed insurers

- Sometimes within the scope of their license
- Sometimes beyond the scope of their license or legislation

Use of pilots by other entities

- Can create difficult issues
  - Customer protection
  - Ability to supervise
  - Unfair competition
- Accept only on a temporary basis, with transitional arrangements
  - Registration
  - Separate identification of assets
  - Deposit
  - Notification of customers
  - Alternative protections

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Common implementation challenges

- Some entities might not realize their activities require a license
- Some entities might not be eligible for a license
- Licensing requirements and procedures might need to be adapted
  - Small entities
  - Different types of entities
  - Pilot schemes
- Small or informal operators might have difficulty understanding or coping with requirements and procedures
- Take steps to remove unnecessary barriers

Formalization and transitional arrangements

- Formalizing informal insurance is generally better than shutting it down
- Start with a clear picture of the current situation and the preferred outcomes
- Protections during a transition are incomplete
  - Transition period should be limited
  - Activities should be constrained
- Processes should be clear and transparent
  - Contemplate contingencies
  - Leverage resources
- Restrictions should be proportionate
- Arrangements should not be unduly attractive

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Changes of control and exit from the market

- Informal insurers that cannot meet formalization requirements
- Failed pilot schemes undertaken by unlicensed entities
- Mutualization or demutualization

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Licensing: Discussion question

Consider the following questions in the context of your respective jurisdictions

1. What types of microinsurance providers are operating?
2. What is their current legal status?
3. What are the transitional arrangements for formalization?

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Operations

- Sound business management means that an insurer practices good corporate governance and sound risk management and internal controls
- The governance and control framework should be proportionate to the complexity and risk of the business

Corporate governance

- Requirements exist to protect the interests of stakeholders
  - For insurers, customers should have high priority
- Nature of conflicts can differ by type of entity
  - MCCOs might not have shareholders
  - Conflicts can still arise among types or generations of policyholders
- MCCOs might have difficulty obtaining a strong, diverse board
  - Management might end up controlling the board
- Unlicensed entities might lack customer-focused governance mechanisms
- Supervisors should ensure governance risks are being dealt with

Suitability of persons

- Key persons should be fit and proper to fulfil their roles
- Small insurers and MCCOs can face particular difficulties
- Encourage strengthening of competence
- Encourage broadening of boards to include non-members of MCCOs
- Consider the use of external experts
- Ensure that suitability requirements are appropriate

Risk management and internal control

- Insurers need to identify, assess and manage their risks effectively
- Control and reporting systems must independent and sufficiently resourced

- If activities are restricted, internal control and risk-management needs may be reduced …
- … innovative approaches can create risks
- … involvement of mixed and non-insurance entities can create control challenges

- Small insurers often face difficulty

Governance: Discussion question

The board of a small community healthcare cooperative is drawn from the membership of the organization.

1. What are the potential advantages of such a composition from the perspective of the insurance supervisor?
2. What are the potential disadvantages?
3. How would your answers differ if the cooperative was large and operated within a broad geographic territory?
4. What steps might be taken to deal with the disadvantages?

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Solvency regime

- Insurers should maintain adequate solvency levels so that they are in a position to meet their obligations to policyholders
- Assessment of the solvency of insurers will consider
  - Reinsurance
  - Liabilities and investments
  - Enterprise Risk Management and capital adequacy
- Solvency regime should be risk-based and proportionate to the complexity and risk of the business

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Reinsurance

- All insurers should have access to the reinsurance they need
- Access to reinsurance might be enhanced by:
  - Formalizing informal insurers
  - Allowing conventional direct insurers to assume microinsurance risks
  - Allowing insurers to reinsure microinsurance products that include both life and nonlife coverages with the same reinsurer
  - Allowing insurers to reinsure new or complex risks with foreign reinsurers
  - Encouraging MCCOs to cooperate with one another in arranging reinsurance

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Liabilities and investments

- Technical provisions should be sufficient to meet the obligations of the insurer
- Restrictions on allowed investments

- Restrict operations commensurate with technical and management capabilities
- Develop simple valuation approaches

- Leverage expertise
  - Share actuarial services

Capital adequacy and ERM

- Capital adequacy requirements aim to enable the insurer to absorb unforeseen losses

- Consider the risk characteristics of products and insurers
  - Low sum insured, simple and short-term products lowers risk
  - Innovative designs and lack of data for pricing increases risk
  - Higher operational risk
- Methodology should be proportionate, not overly complex

- MCCOs can face particular difficulty in raising additional capital

Reinsurance: Discussion question

Consider the following questions in the context of your respective jurisdictions

1. Are there any types of insurers that face a significant risk of failure because they lack access to suitable reinsurance?
2. Are there any types of products that cannot prudently be offered because suitable reinsurance is unavailable or difficult to arrange?
3. What steps might be taken to enhance the access of insurers to reinsurance?

Supervision

- The supervisor should take a risk-based approach to supervision of the industry that involves
  - Reporting and off-site analysis
  - On-site inspection
  - Prevention, correction, and enforcement
- The supervisor will evaluate the financial position, risk profile and effectiveness of its corporate governance and its compliance with supervisory requirements of the insurer

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Risk-based approach

- Large, complex insurers should be subject to sophisticated risk assessment
- Small, simple insurers might be subject to a more standardized approach
- Synergies with apex organizations and other authorities might be possible
- All relevant entities in the insurance delivery chain should be considered

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Reporting and off-site analysis

- Information should be sufficient
  - Supervisory assessment
  - Market analysis and policy needs
- Analysis by class of business for combination products
- Benchmarks might differ from conventional insurance

- Requirements should be proportionate
- Consider the sophistication of the record keeping and reporting systems of the insurer

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On-site inspection

- Inspection program might differ for small, geographically remote insurers
- Focused inspections of microinsurance activities of conventional insurers might be practical
- Obtain access to all entities in the delivery chain

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Prevention, correction, and enforcement

- Basic framework might be unchanged
- Additional communication of requirements and expectations
- Transitional arrangements should be enforced
- Replacing key individuals might be particularly difficult
- Financial penalties should be proportionate

- Focus on taking measures to protect consumers

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Assessing the risk profile: Group activity

- A large agricultural cooperative has been providing crop insurance to its members on an informal basis.
- Five persons are directly involved in the operation of the insurance program. None of them have formal training in insurance.
- The cooperative charges premiums sufficient to break even over a five-year period, based on past claims experience. It accumulates a reserve, which is invested in an account at a local bank.
- The cooperative plans to set up a subsidiary, for which it will seek an insurance license, as is now required.
- The head of your authority has asked you to compare the likely risk profile of this potential applicant with that of a large and well-run conventional nonlife insurer

What differences are likely within the various risk-assessment categories used by your authority?

- Financial: assets, liabilities, capital, earnings, group
- Operational: ownership, governance, business activities, controls
- Market conduct: business activities, controls

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