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P R O G R E S

Research Programme on the Service

International Association for the Study of Insurance Economics

Geneva Association Information Newsletter

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The Geneva Association

The International Association for the Study of Insurance Economics, or by its short name "The Geneva Association", is a unique world organisation formed by a maximum of 80 chief executive officers from the most important insurance companies in the world (Europe, North and South America, Asia, Africa and Australia). Our main goal is to research the growing importance of worldwide insurance activities in all sectors of the economy. We try to identify fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. In parallel, we develop and encourage various initiatives concerning the evolution – in economic and cultural terms – of risk management and the notion of uncertainty in the modern economy.

The Geneva Association also acts as a forum for its members, providing a worldwide unique platform for the top insurance CEOs. We organise the framework for our members in order that they may exchange ideas and discuss key strategic issues, especially at the General Assembly where once per year over 50 of the top insurance CEOs gather. The Geneva Association serves as a catalyst for progress in this unprecedented period of fundamental change in the insurance industry and its growing importance for the further development of the modern economy. It is a non-profit organisation.

The PROGRES Research Programme

The PROGRES name stands for research **PROG**ramme on **RE**gulation, **S**upervision and legal issues in insurance. It focuses on questions related to regulation, supervision and international co-operation of insurance and financial services as well as other legal issues of importance. The research programme manages The Geneva Association's co-operation with the supervisory authorities around the world and in particular with the International Association of Insurance Supervisors.

The annual PROGRES seminars address on advancing the regulatory and legal debates as well as trade and international co-operation issues.They provide since 1983 an annual forum and focal point for up to 60 specialist inter-disciplinary participants – private-sector practitioners and experts from representative organisations, academics, officials from governments and intergovernmental organisations – to discuss and debate in an informal way.

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The Geneva Association Information Newsletter – PROGRES, No. 41, June 2005
Newsletter on Regulation, Supervision and Legal Issues

This bulletin of the Research Programme on the Service Economy is meant to contribute to the exchange of information on studies and initiatives aimed at better understanding the challenges avising in the fields of insurance regulation, supervision as well as other legal aspects. It is published biannually by the Geneva Association. Any suggestions concerning the content or layout of the newsletter are welcome. Please notify us if you are interested in receiving this publication regularly.

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I. EDITORIAL

By Dr Knut Hohlfeld

Insurance fraud is detrimental to insurers as well as to consumers

In January 2005 the Insurance Research Council (IRC) issued a news release referring to a study on fraud and buildup in auto injury insurance claims in the United States. According to this study, fraud (misrepresentation of key facts of a claim) and buildup (intentional inflation of an otherwise legitimate claim) added approximately $5 bn to auto injury settlements in 2002, representing nearly 15 per cent of all dollars paid for private passenger auto injury insurance claims in that year. This means already an improvement compared to the situation ten years ago. A previous study had found that fraud and buildup had added nearly 20 per cent of total claims dollars paid in 1992. The study of 2004 examined detailed claims information from around 72,000 claims that closed with payment in 2002. Thirty-two insurers participated in the study representing nearly 60 per cent of the 2002 private passenger auto insurance market in the U.S. Fraud was found in almost 10 per cent and buildup in 20 per cent of paid bodily injury liability claims.

These are alarming numbers. Insurance is based on trust. This is commonly understood in the sense that the policyholders must be able to trust that their insurers will meet their obligations under the insurance contracts at all times. It is the principal task of insurance supervision to secure that this trust will not be disappointed.

The results of the study of the IRC prove that the trust of insurers in the information of policyholders and insured can also be disappointed. Claims fraud is not a peccadillo, it is a punishable offence. It is irreconcilable with the idea of solidarity that insurance originally is based upon and expresses pure egoistic and even criminal behaviour to the debit of the honest policyholders who have to pay accordingly increased premiums. Insurers therefore must allocate appropriate resources and implement effective procedures and controls to deter and detect fraud and promptly report fraud to the police and prosecutors.

Combating fraud requires the cooperation of the insurance companies. In Austria, for example, a special Office for Combating Insurance Fraud (Büro zur Bekämpfung des Versicherungsbetrugs, BVB) has been established as an integral part of the Association of Austrian Insurance Companies. This Office, in particular, manages a central information system which registers cases of fraud in motor insurance. The cooperation of the insurance companies, however, still leaves much to be desired. The companies are sparing with reporting cases of fraud and shrinking from admitting that they have been subject to fraud. Further, one has to take into account the fact that the central information system must not violate data protection provisions.

Realising that better combating insurance fraud is preferable to increasing premiums the Seminar of insurance business management of the Vienna University on Economics in cooperation with the BVB recently developed a business plan for the BVB recommending improvements of its organisation and work routines in order to increase the efficiency of its work. Should this be successful then the model could be of interest to other countries too.

We should further welcome the fact that the IAIS is currently developing a guidance paper on fraud on insurers differentiating between claims fraud, internal fraud and intermediary fraud. This guidance paper will not refer to motor insurance in particular but will cover all branches of insurance.

Insurers as well as consumers would very much profit if insurance fraud could be considerably diminished.

About the editor: Dr Knut Hohlfeld is the former President of the German Insurance Supervisory Authority and former Secretary General of the IAIS. He now heads The Geneva Association's PROGRES Research Programme as its Director.

II. MONEY LAUNDERING AND THE GENERAL INSURANCE MARKET— THE CHALLENGES AHEAD

By Andy Wragg[*]

In April 2005, I attended the PROGRES seminar in Geneva to talk about the challenges facing the general insurance market, particularly in the UK, from money laundering. Predicting the future is never as easy as simply reporting the present and as a result I undertook some research into this area. This research led me to realise just how much anti-money laundering legislation is evolving and how the insurance industry is becoming a focus area for regulators.

General insurance traditionally is considered to face a significantly lower risk of money laundering than other financial sectors. This comparison even extends to the life insurance industry where a higher risk of money laundering is perceived due to the assumption that insurance products with cash value, such as single-premium life insurance polices or annuity contracts, are a preferred vehicle for criminals to launder funds.

In the UK (and other jurisdictions), the lower perceived risk is reflected by the fact that general insurance falls outside of the scope of the money laundering regulations. In addition the relevant section of the Proceeds of Crime Act 2002 addressing money laundering puts general insurance outside the Act's regulated sector. The effect of this means that the general insurance sector is not compelled to conduct a KYC ("know your customer") on each business relationship. Unlike the regulated sector, general insurers also cannot face a charge of failure to report a suspicion of money laundering when only **reasonable grounds** for suspicion exist (failure to report **actual** knowledge or suspicion is still an offence).

A lesser compliance burden placed on the general insurance market creates its own challenges and there may be a tendency to become complacent. I have heard it said by some that money laundering does not/cannot occur in general insurance. Unfortunately, low risk does not mean no risk. At Lloyd's for example we have seen a number of money laundering attempts, fortunately thwarted due to the diligence of those in the market. Most cases that we have seen at Lloyd's have been relatively unsophisticated attempts at fraud but we have seen a number of cases that, had they been successfully completed, could have caused serious damage. Consider, for example, if you as an insurer unwittingly became involved in the following offered to you by an insurance broker:

You are offered the opportunity to write a reinsurance contract for a well-established Caribbean insurer. The reinsurance premium offered is very good. The underlying coverage is fidelity insurance (directors and officers) for a number of well-known investment firms based in the U.S. and it is projected that the annual premium paid by the investment companies to the insurer will be in excess of U.S.$ 15million.

Are you happy to proceed? If not, why not? On the face of it this is a very attractive risk and as a reinsurer you have an excellent opportunity to make a good profit.

This was an actual insurance risk referred to the authorities. Things were not what they seemed. Underwriters, for a number of reasons, were suspicious about the reinsurance offer. Firstly, the Caribbean insurer was unknown to underwriters - despite having been advised that the insurer had been in existence for some 20 years they could find no information on the company. In addition, the reinsurance premium being offered was 4 times the market rate at the time and seemed just too good to be true – a company seeking reinsurance coverage at any price did not give comfort to underwriters. A suspicious transaction report was therefore filed and the City of London Police Fraud Squad in conjunction with overseas law enforcement and regulatory authorities investigated, discovering the following:

All investment companies were fictitious "brass plate" organisations. All had been established by the same underlying individuals and had links to organised crime. These so-called investment

[*] The views expressed are those of the author and do not necessarily reflect those of Lloyd's.

companies did have clients but they were not "investors" in the usual sense of the word. Many of the clients were known to the authorities; most were believed to be involved in drug trafficking and were suspected to be laundering vast amounts of money through the investment companies.

And what of the Caribbean insurer? It was discovered that the underlying ownership was the same parties that were involved with the investment companies. In addition, the company had not been established 20 years ago, as had been claimed, but in fact an application for authorisation was in the process of being considered by the authorities in the Caribbean country concerned. And why the request for reinsurance? The Caribbean authorities, in considering the application for authorization, were being given comfort by the fact that once authorisation was granted, reinsurance protection was in place and "ready to go".

Law enforcement quickly unravelled the case and took action against the parties involved, before this attempt at establishing a money laundering operation got off the ground. If it had, serious reputational damage could have been caused to the reinsurers unwittingly involved, if the criminal activities of the investments companies and Caribbean insurer had ever come to light. Fortunately, underwriters were fully aware of their duties in reporting their suspicions to the authorities and this was averted.

The preceding example is an extreme case but does demonstrate the potential for money laundering in insurance and emphasises the reputational risks (regardless of the legal and criminal penalties) to those in this industry who are not alive to the dangers.

For our industry to be able to dedicate already stretched resources to areas of most risk, we all must be willing to share our experiences and build upon the limited amount of money laundering typologies that exist in this industry.

Fortunately, organisations such as the International Association of Insurance Supervisors (IAIS) and the Financial Action Task Force (FATF) are conducting extensive work in this area, and the FATF is expected to publish its review of the threats to the insurance industry from money laundering and terrorism imminently. This is bound to build upon the limited knowledge base of insurance money laundering typologies that currently exist. The work needs to continue, and sharing examples of cases with the IAIS and FATF should be everyone's responsibility.

In undertaking my research for the PROGRES seminar, I noticed a number of recent articles in the UK press which indicated that the regulatory authorities are certainly alive to the risks of money laundering in insurance. Headlines such as "Laundering battle turns toward insurance market", "Money launderers targeting insurance industry" and "Insurers under regulatory scrutiny on suspicion of money laundering" clearly show this to be the case.

These headlines reflect the change in attitude by regulators and law enforcement towards the insurance industry. It is clear that they feel the industry is not stepping up to the mark in the fight against money laundering and funding of terrorism. A recent report by the UK's National Criminal Intelligence Service made the following point:

"The diverse nature of general insurance…exposes the market to numerous threats. Fraud is considered to be the largest…and as such little attention is given to laundering…"

The 2004 annual FATF report also made the following point about the insurance industry: "…those parts of the financial system in which anti-money laundering procedures are inconsistently applied are those that are at most risk of exploitation for money laundering purposes".

If the spotlight in the fight against money laundering has turned the way of insurance, what can we expect? It is not of any great surprise that the U.S. has already acted. In November 2004 it was announced that the full provisions of the 2001 USA Patriot Act would be applied to the life insurance industry. So what is likely to be the approach adopted by other regulatory regimes in due course? That is of course difficult to predict but the FATF has already stated in its 2004 report (announcing its investigation into the extent to which the insurance industry is being targeted by money launderers and terrorists):

"The nature of the money laundering risk in the insurance sector appears to be different from that which exists for the rest of the financial sector; consequently, there may be the need to develop industry-specific AML measures".

So what is likely to be the way forward? Current IAIS guidance has referred to a need for a risk based approach to be adopted by insurers to assess the money laundering risk of each business relationship. The guidance moves away from the traditional KYC approach of customer verification to a risk based approach now referred to as Customer Due Diligence (CDD). Where enhanced CDD is necessary for a business relationship, the elements to be covered include identification and verification of the customer and any beneficial owners, obtaining information on the purpose and intended nature of the business relationship and conducting ongoing due diligence on that business relationship.

This approach, whilst perhaps adding a level of compliance that did not exist before, does give each insurer the opportunity to make their own assessment of the money laundering risks for each business relationship. The IAIS also makes the point that once the level of risk has been established, different levels of CDD can be applied, i.e. high risk means the enhanced due diligence outlined above and low risk would be a much more simplified level of due diligence. Regulators, undoubtedly, will want to see that the reviews undertaken by their firms are thorough and well thought out.

One area that regulators will need to address is the issue of insurance intermediaries. It is important to ensure that the implementation of anti-money laundering controls is applied equally to the broking community, as intermediaries often have more information about a risk than insurers, information that should raise suspicions and be reported. There has been a tendency in the past for some intermediaries to ignore their suspicions and seek to place insurance at any cost – a "never mind the quality, feel the commission" approach. Whilst it is unfair to level this accusation at all intermediaries, it is clear that this needs to be addressed by regulators.

Despite what has just been said, insurers have to accept that the responsibility for CDD rests with them. This means being satisfied that any due diligence performed by an intermediary on their behalf is adequate.

In summary, therefore, the general insurance industry is facing a number of challenges in the fight against money laundering:

- Remaining aware of the threats from money laundering and developing typologies to share with the rest of the industry to help negate those threats.
- Regulators are beginning to consider industry-specific guidance, and regulations of one kind or another will come the insurance industry's way.
- Keeping ahead of the game and developing established due diligence processes to apply to issues such as CDD and assessing the money laundering risks for all business relationships.

Finally, the UK's Joint Money Laundering Steering Group sums up the changing regulatory focus and opportunity for firms, as follows:

"Firms should be encouraged…to have systems in place to highlight those who, **on criteria thoughtfully established by the firms**, may indicate that they present a higher risk of money laundering".

Developing this effective and workable approach to the threat from money laundering is **the** challenge for regulators and insurers alike in the general insurance industry.

Author: Andy Wragg has been involved in investigating cases involving the fraudulent use of Lloyd's name for over 15 years and heads up Lloyd's International Regulatory Liaison department. In the money laundering arena, Andy has issued guidance to the Lloyd's insurance market to assist compliance with UK anti-money laundering legislation and regularly provides talks to insurers, law enforcement and other bodies on the impact of money laundering on the UK insurance industry.

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III. IFRS ON INSURANCE—PHASE II

By Dr Joachim Kölschbach

The **IASB** as well as **IASB's Insurance Working Group** held their first meetings on insurance topics starting in September 2004.

IASB meetings

The IASB held meetings in September 2004, January, February, April and May 2005 with mostly educational content. They also reviewed their project plan on insurance and their position for non-life contracts.

Educational sessions were held on **non-life insurance contracts** only. A presentation, led by the International Actuarial Association (IAA) dealt with claims liabilities. Various presentations on discounting and risk margins were held by the Casualty Actuarial Society, Tillinghast and PwC, the General Insurance Association of Japan, the Group of North American Insurance Enterprises and Ernst &Young and Australian and Canadian members of the IASB Insurance Working Group.

In the January meeting, the Board reviewed the project plan for Phase II. They decided that the Board would take a fresh look at financial reporting by insurers, starting from a blank sheet of paper. Past work by the Board has been a useful resource, but the Board does not feel bound by it. The only restrictions are the IASB's Framework and the general principles established in the existing Standards. They are looking forward to a close interaction with the FASB and support the IASB/FASB convergence.

The Board identified important interactions with other projects, especially those on the conceptual framework, revenue recognition, accounting measurement, performance reporting, financial instruments, revisions to IAS 37 and the project on liabilities and equity. Board members noted that the work on insurance contracts would proceed in parallel with these other projects and should not wait for their outcome. Furthermore, work on insurance contracts may generate useful inputs for those other projects.

The planned timetable now foresees the publication of a discussion paper not before the end of 2005, an exposure draft not before mid-2007 and a final standard not before mid-2008. For that the earliest effective date might be 2010.

The main issues identified are subject to the discussions within the IASB Insurance Working Group.

In the May meeting, the Board made first preliminary decisions to direct the ongoing development. It was unanimously decided that claims liabilities should be discounted and shouldl include a provision for risk and uncertainty.

The application of discounting and provisions for risk and uncertainty is subject to the general requirements on materiality, i.e. there is no special relief for insurance contracts in Phase II.

Stand-ready obligations are measured either at the unearned portion of premiums received, potentially less acquisition cost, or measured prospectively as future obligations, including discounting and provisions for risk and uncertainty. If the stand-ready obligation is reported at the unearned portion, a liability adequacy test is applied, considering as well provisions for risk and uncertainty.

The future standard will provide the same degree of detail as other the standards do, i.e. not being prescriptive in the methods which have to be applied, but providing principles.

IASB Insurance Working Group meetings

The IASB Insurance Working Group (IWG) was set up by the IASB in 2004 as a supportive technical group which does not have any decision-making power. Taking decisions is still a matter reserved for the Board. The Insurance Working Group held meetings in September and December 2004 as well as in January and April 2005. The next meetings are scheduled for July and September 2005.

The first meeting was devoted to identifying of issues and their prioritisation. In the following meetings non-life as well as life insurance topics were discussed.

Up to now, the Board has identified 14 issues concerning life and non-life insurance, but not all have been already discussed within the Insurance Working Group. The following gives an overview of the status of the specific issues:

The IWG discussed four **models**: (A) Lock in, (B) Amortised cost, (C) Current entry value and (D) Current exit value. Board members did not favour one of the approaches but the most preferred models are those including discounting of insurance liabilities and provisions for risk and uncertainty. At the moment it is very likely that the Board will put forward only one model in its discussion paper, which then might be a combination of two or more approaches. The IASB staff decided to pursue models A, C and D for future meetings. B was given up as it did not find much favour with the participants. It was agreed that the European embedded value model would be put forward as another alternative.

With respect to the **measurement basis**, the asset and liability definition in the Framework was clarified. For insurance purposes, there will be no deviation from these definitions. It is likely to go down the Asset/Liability way due to the approach of the Revenue Recognition and Conceptual Framework project.

Concerning **policyholder behaviour**, there was a lot of discussion about renewal premiums. Firstly, the discussion focused on whether liabilities should be based on the concept that all policyholders or an expected level of policyholders will renew their policy. Secondly, the question was asked whether these could be recognised in the valuation of the liability. Board members were united in the opposition to recognising future renewals as insurance companies did not control the payment of these premiums.

There are strong conceptual arguments for **discounting**. While there were concerns raised over the uncertainty of estimating claim liabilities and of then adding a series of discounting assumptions, discounting would seem to be supported by the IASB's conceptual framework. There was some discussion as to whether this particular liability could be reasonably represented on a discounted basis due to the inherent uncertainties in estimating the cash flow periods. However, it was agreed that a risk margin would also be an appropriate adjustment if the liability were discounted. It is most likely that **investment margins** will not affect liability valuations.

With respect to a **gain or loss on initial recognition**, some Board members favoured a loss to be recognised at inception since that showed the true economic position, whereas the industry is united in its opposition, stating that the accounting would not reflect economic reality when the contract, which was intended to be profitable, would be shown as making a loss at inception.

The IWG also discussed about the appropriateness of **deferred acquisition costs** within the IASB Framework. Some of the ideas discussed included whether it was appropriate to record a deferred cost at inception, whether this was a recoverable cost if the contracts were sold and whether this item should be considered in conjunction with unearned premiums. The debate on renewals also focussed on whether an intangible asset could be recognised as reflecting the right to future profits arising from insurance contracts. There was a suggestion that the value of the intangible asset would be restricted to the level of the acquisition cost.

The discussion on **participation contracts** was on the question of what constitutes constructive obligations and what bonuses can be reflected in the liability valuation. The discussion's focus was on what is the past event which creates the obligation. This depends also on the new definition/concept of constructive obligation which is currently being revised and will be published with an exposure draft by end of June. Further discussions focussed on whether unallocated surplus would be classified as debt or equity.

The **risk service adjustments** still remain a very difficult area for progress.

There was no discussion so far on unbundling, credit standing, options and guarantees, asset/liability interaction and changes in assumptions and estimates.

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IV. A RISK MANAGEMENT APPROACH TO THE COST OF CAPITAL—GREAT CHALLENGES FOR BUSINESS, INSURANCE AND REGULATORS

BY ESKIL ULLBERG

Cost of capital

To define cost of capital, we use the Capital Asset Pricing Model (CAPM)[1] of market risk and company-specific risk, expressed as the beta value[2]. A high beta indicates higher but also more uncertain (risky) returns and a low beta a lower risk but also more certain returns.

Capital plays an important role in addressing the business risk and uncertainties: financing business transactions, developing new products, services and intellectual property and protecting consumer interests with respect to long-term promises given by companies. In the "service economy" risks are generally shifted toward the more uncertain future, making it more risky but also more productive with better allocation of resources as a result. The last role of capital is very present in insurance. To succeed in managing these risks effectively at acceptable cost, new knowledge, mechanisms and markets need to be developed.

Technology has reduced transaction risks and capital markets have become more efficient in financing growth through new derivatives (options, etc.). Protection of the consumer with capital, however, remains an important risk issue in particular for insurance companies.

The insurance industry is very skilled on the "uncertain future side" but the "banking side" is somewhat less developed. This is now coming together in Bancassurance since the deregulation of a whole series of financial services in many countries in the 1980s. Banks however are less experienced in business risk thinking. The "time value of money" has been the driving force here, not always business risks that are managed through processes, methods, etc. Collaterals are therefore (almost always) taken out to protect against potential future losses.

The result of deregulation is that governments move away from a "lender of last resort" role, and the insurance companies now need to capitalize to protect the consumers. Risk is thus transferred to the private sector. The cost of managing these risks is thereby also moved to the insurance industry and its customers. They therefore compete for funds required to finance **future** growth with funds required to protect obligations taken in the **past**. This situation creates an interesting "battle" for capital in the financial markets. Different instruments may be **needed** to separate these in different risks and invite investors with the right risk appetite, in order to create an efficient financing mechanism.

How can we strike a balance here that both protects the policyholders and meets the needs to free up capital needed for economic growth without introducing any additional systemic risks in the financial system at the same time? The answer may be in the market.

Some challenging numbers for the insurance industry, regulators and supervisors

During the last 5 years the cost of capital for the listed Top-10 banks and insurance companies on Wall Street has changed place: A 50 per cent increase in cost of capital in **real terms** for these insurance companies and a 30 per cent decrease in cost of capital for the banks in question. During the same period the cost of capital of the market as a whole has largely remained the same (in real terms) at about 9-10 per cent. The risks are thus not higher, just shifted.[3]

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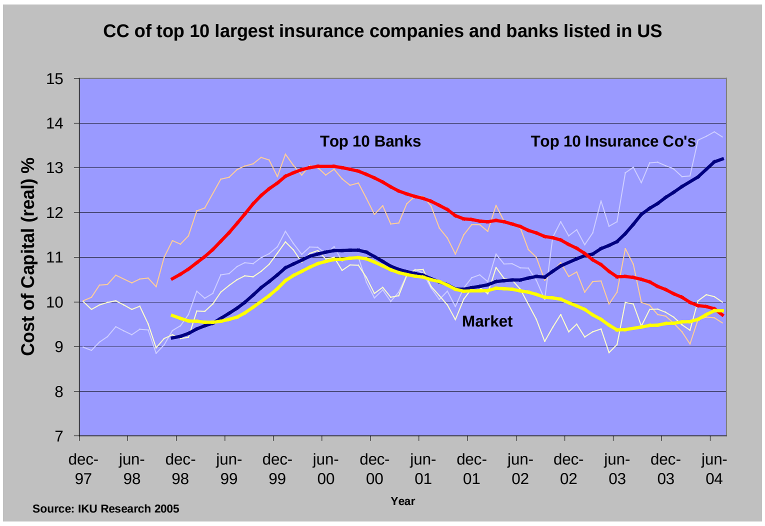
[1] Sharpe, et. al. based on the portfolio theory of Markowits, both Nobel price laureates.

[2] An example: SwissRe had a beta value of 1.21 during July 2004. The risk free rate taken by US treasury bonds were at the same time 4.5 per cent and the long term market risk premium used is 8.3 per cent, thus the expected return of Swiss Re, its cost of capital, equals 1.21 * 0.083 + 0.045 = 0.128 or 12.8 per cent.

[3] Fig.: Cost of capital based on average monthly beta values of top 10 banks and insurance companies on Wall Street. Market Risk=5.5 per cent, Risk free rate=US Treasury bonds. Data from DATASTREAM.

The uncertain exposure of the top banks in the 1990s is gone. This is partly due to Basel I (and maybe anticipatory actions towards Basel II).

With Solvency I and II the risk portfolio of insurance companies may need to be adjusted. This also means that the expectations on returns go down. It may in turn prove difficult to raise the extra capital needed. This development creates a need for new instruments to deal with these risks and maybe new markets for new risks also (for example in insurance policies/contracts which later can be securitized).



The efficiency in capital allocation

As the allocation of resources becomes more efficient in the economy as a whole so the capital has to be effectively allocated.

These needs may constitute a problem that regulators wish to think twice about. Here the temptation is to add more "red tape" or to allow more freedom for these new instruments that can be traded in new markets. The former, if too harsh, may stifle growth and also add to the complexity by creating "tax-like" effects on markets[1]. The latter can introduce incentives to innovate but needs to be managed in a more active way, adding demands for transparency and market discipline. Increasing the amount of capital adequacy also increases the cost of the funds needed to meet the demands but not necessarily the cost of capital the company has to pay for new capital. The former impacts the **profits** and **availability of capital** in the capital markets and is based on the *regulator's view on risk* (in the case of the Solvency II there are "minimum" and "solvency capital" requirements). The latter, however is related to the risk taken on by an investor and priced by the capital markets. A more deregulated view on the capital demands may therefore lead to a more correct and competitive allocation of capital. However, as mentioned, this probably requires new tradable instruments, which in turn requires freedom to market access and must be allowed to cover solvency demands.

High demands for capital by a big and thirsty industry may siphon funds for other investments having macro-economic impact, thereby decreasing growth financing. The industry can thus be so solvent that it may affect growth by "putting some talents in the ground". At least they should be put in a bank but most preferably put in productive use at risk. There may therefore be limits to solvency demands in order to give incentives to a competitive insurance industry in Europe.

Markets versus regulation in insurance

This optimal allocation is probably best done in a market where these risks are given a price and traded. This would allow a wider range of investors to provide capital for the insurance industry's needs, an industry described by O. Giarini and The Geneva Association as being a very essential economic activity.[2] New instruments in this field would allow the creation of solvency for the "insurance system" in a potentially more efficient way than today. The recognition of new tradable instruments as part of solvency assets becomes a key *strategic* issue to be decided on.[3]

[1] During the 21st PROGRES seminar an interesting analysis method of "tax equivalents" of trade related decisions was presented as a possible input for trade negotiators and policy makers.
[2] See a number of articles by Orio Giarini, Patrick Liedtke and The Geneva Association during the past 30 years on insurance and economics and PROGRES seminars and others.
[3] K. Arrow's case for government "insurance" schemes in the early 1960's was based on that those risks were not traded in markets and therefore the state was best positioned to assume the risks. Having markets or creating markets allows for more efficient allocation of resources. Also referring to an article by G. Priest, 26th annual lecture of The Geneva Association, on government and market insurance.

Examples of such financial instruments are super subordinated debt[1] (or “deeply subordinated debt”). These instruments are useful to cover solvency requirements in case of financial losses. Risk is thereby absorbed with more actors sharing the risk. On the other hand this will shift supervision to capital market disciplines, corporate methods of managing risk and increased transparency. Conclusion: A more **systemic** framework based on overall principles of market disciplines.

Another instrument of risk management interest is securitization of insurance policies. This would further diversify the **business** risks (the liability side in insurance). Risk, initially held by the government, now held by the insurance industry (see the graph) will then be transferred to other more specialized actors with the right risk appetite. These mechanisms thus replace a regulatory system in part by providing a market price on these risks. Higher efficiency would be achieved and capital would be put to more productive use in the economy.

Other techniques that can play a key role in managing business risk are: intellectual property rights, operational processes and methods.

- Risk management can be seen as: a unique way to allocate resources effectively. This is thus intellectual capital. *Intellectual property rights*, IPRs, can here be used to protect and trade some ideas in relation to risk management, in particular in relation to information technology. The trade of these rights allows for specialization and thus a more productive use of R&D resources, in this case, to develop new ways to manage risk and uncertainty.[2] This would reduce the need for capital by acquiring a *strategic* advantage in risk management.

- Operational processes may prove to be a competitive edge for companies to deal with cost of capital. Allowing a company’s “own models” to manage risk where the results can be monitored would be a way to allow companies to differentiate between themselves.

The insurance industry would ultimately have a lighter balance sheet with the asset and liability risks traded in markets and would be able to focus on … insurance. A specialization on **insurance**, which thus increasingly would compete at the level of **intellectual property**, **financial risk management** and **new markets** to trade and monetize policy risks, would lead to a more efficient industry and thereby lower cost of capital.

A strategic shift in demands

Another big issue is that by putting too severe demands on solvency the question would be raised of whether such a system will change the demand patterns. There is always an alternative and here we explore several alternatives:

- Increased self-insurance – this is already happening in health insurance, car insurance, private pensions, etc. The lack of efficient markets in insurance contracts has turned this development into a major socio-economic issue.

- Captives – these will also be under Solvency II requirements.

- Other means to finance the industry – here capital markets and securitization move risks out of Solvency II demands and into Basel II area. Only new instruments that take into account the risks *actually* mitigated are efficient since there is an obvious systemic financial risk of regulatory arbitrage here.

- A more administrative, i.e. market-oriented way, to deal with breach of rules would be preferred to investigations and courts. A clear (and simple) administrative procedure would reduce uncertainty for market actors. Perhaps this will be possible with Solvency II, and the separation of target capital requirement from minimum capital requirement may enjoy a more administrative approach. MCR on the other hand seems to be an entry ticket for the industry to be accepted.

[1] If the insurance company pays out dividends, the debt remains a debt. If not then the instrument becomes capital to cover losses. It is an option with a risk sharing that gives high return at high risk. Reference is made to discussions touching this issue at the 21st PROGRES Seminar as well as input from discussions with the industry.

[2] See “Financial risk and the patenting system – A risk management approach”, PROGRES June 2004, Ullberg, for some more thoughts and trends on this subject.

Conclusions

Some issues – not all – have been raised. The most important ones are:

- Focus on the **management** of risk in a market context
- New markets for "insurable risks"
- Some regulations needed – to have clear market disciplines
- Minimum solvency demands – a reasonable entry ticket for the business risk. This will probably give incentives for new instruments to trade business and financial risk.

The bottom line is to find an efficient **overall** capital allocation in relation to available capital in the economy. Here thorough analysis needs to be made of course. New instruments, methods and markets may be needed to provide an efficient allocation of capital.

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SPECIAL ISSUE OF THE INSURANCE AND FINANCE NEWSLETTER

The Geneva Association has published a special issue of the Insurance and Finance newsletter on The Geneva Association's **Insurance and Finance Conference** of 11-12 November, with a summary of the conference from Stefan Schürmann.

The full conference proceedings, running to a total of 172 pages are available from the General Secretariat of The Geneva Association as part of the Working Paper Series "Etudes et Dossiers".

Contact the Secretariat at secretariat@genevaassociation.org to order copies of the two documents.

V. STRUGGLING WITH REGULATION: A MAJOR CHALLENGE FOR EUROPEAN INSURERS

By Lucia Caudet and Christian Pierotti

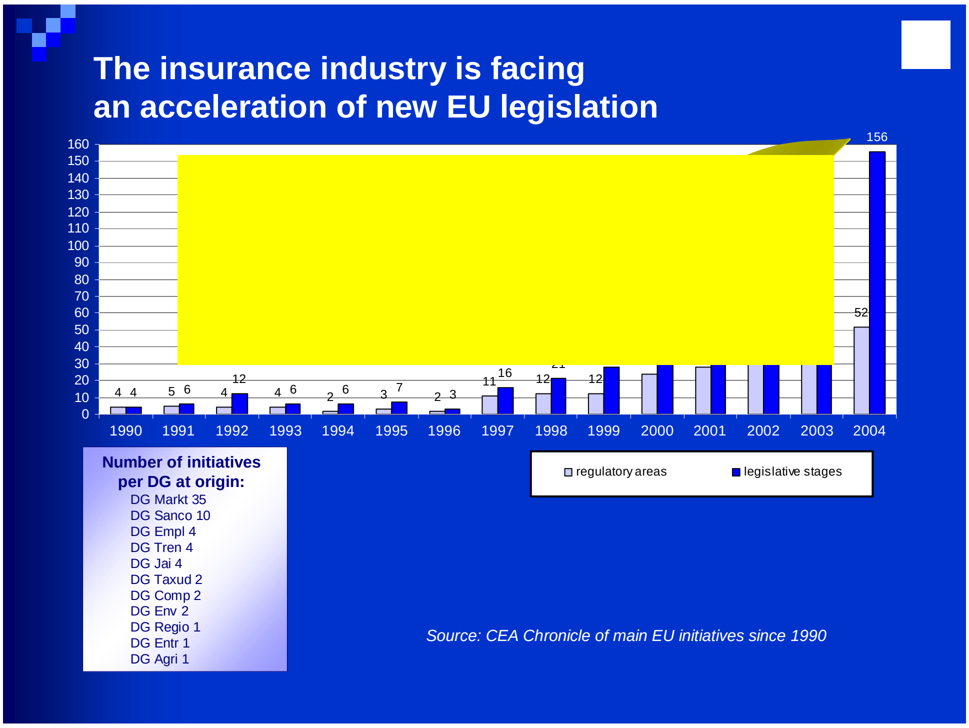
In recent years, the European insurance regulatory environment has fundamentally changed to become what could be described as a huge and chaotic building site. The European Union's unprecedented regulatory frenzy put insurers out for the count. At the same time, we have seen an increasing number of legislative, regulatory and supervisory bodies influencing the sector's operating conditions.

Making EU regulation fit those it is designed for

The volume of regulation has certainly become a major issue for insurers over the past decade. While in 1994 the EU worked on two insurance-related areas (prudential supervision and environmental liability), the number had risen to a vertiginous 52 in 2004.[1] Analysing, contributing to and implementing this wave of regulation has left the industry gasping for breath. The problem is not only that excessive regulation is hard to monitor and influence, but more importantly that it is not always properly designed for those it should suit.

[1] Source: CEA chronicle on insurance-related EU initiatives since 1990

Table 1: The insurance industry is facing an acceleration of new EU legislation



CEA has been stressing that regulation should be driven by real commercial and customer needs. Unfortunately, this is not always the case. European insurance regulation is often marked by inconsistency, excessive complexity or too much red tape. There is certainly some room for improvement when one considers, for example, that the different methods of selling insurance have been regulated separately and, as a result, consumer information requirements vary according to whether insurance is sold face to face, via telesales, or through the Internet.

On 3 May 2005, the European Commission indeed presented the long-awaited Green Paper on its Financial Services Policy for 2005-2010. Most CEA arguments have been taken on board. The paper represents a great step forward in EU policy-making. Following a period of cumulating regulatory initiatives, the European Commission now seems to be aiming at achieving real progress in the integration of the Single Market by means of better regulation.

The legislative institution and its Single Market Commissioner, Charlie McCreevy, had already given positive signs in past months that no “FSAP – Part II” was to be expected. European insurers warmly welcome the announced regulatory pause.

Prior to launching new initiatives, the Commission intends to focus on the consolidation of existing legislation, its effective transposition into national law and the evaluation of its results. The Commission’s readiness to amend, or even withdraw, existing legislation if it proves not to meet the expected economic benefits, is highly unusual and praiseworthy.

CEA further welcomes the commitment to base any future Single Market legislative proposal on rigorous impact assessments and extensive consultation of consumers and the insurance industry. This is the only way to make sure regulation is designed for those it should fit.

The Green Paper further addresses the need for greater convergence between national regulators. European insurers have pointed out that lack of guidelines for Member States on the interpretation of provisions lead to distortion in the application of the same text from one country to another. Greater coordination is also needed among supervisors, not least to reflect pan-European group needs.

The Commission remains concerned about the low level of integration in retail financial services. It is true that the level of cross-border trade in financial services remains low. According to the Commission 2004 “Eurobarometer” survey, only 1 per cent of respondents had ever purchased life insurance cross-border and only 5 per cent contemplated ever buying life insurance across borders.

The current level of cross-border retail activity should not in itself be a trigger for legislative activity since it simply reflects the nature of insurance. Consumers are more interested in buying insurance from familiar local providers because of, among other factors, the need for proximity after-sales service as well as cultural and language reasons. Additional legislation will hardly change that.

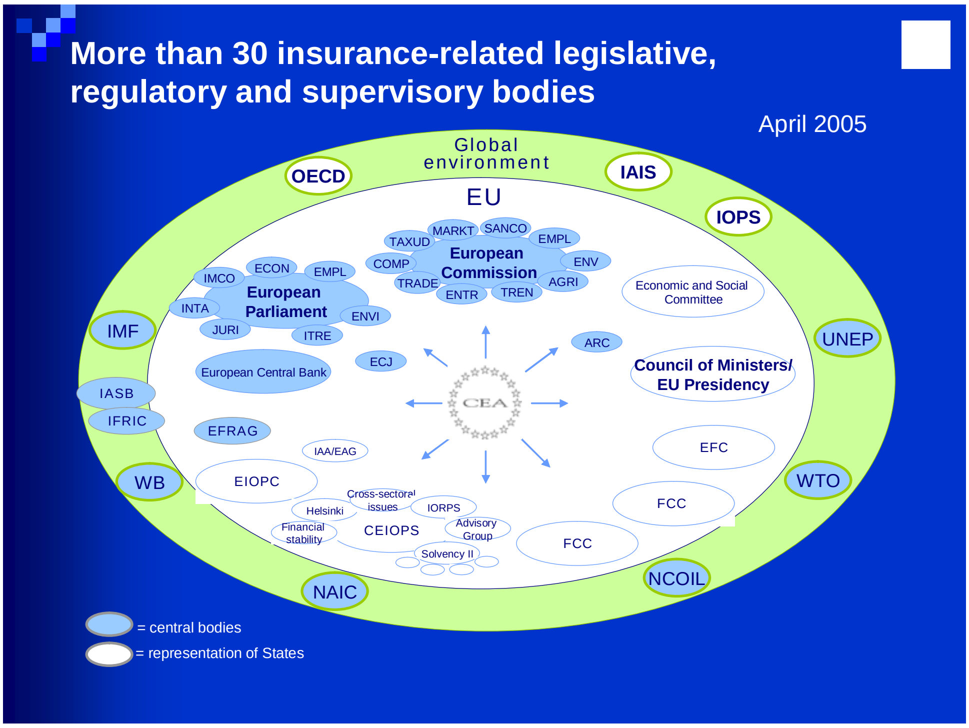
What legislation can change is the number of obstacles still facing large pan-European groups likely to offer retail insurance products, e.g. diversity of supervisory practices and accounting rules. Fortunately, Solvency II and International Financial Reporting Standards figure among the EU priorities. As regards other factors which could help the level of cross-border business to grow over time, they should be determined by market forces.

The Green Paper will be submitted for public consultation until 1 August and a final programme should be presented in November. CEA welcomes the fact that the European Commission has taken into account most of the insurance industry’s messages and looks forward to participating in the debate it has launched.

Promoting European insurers’ position in an international environment

European insurance regulatory conditions are not only determined by EU regulators. They are also increasingly influenced by international bodies such as the International Association of Insurance Supervisors (IAIS), the World Trade Organisation (WTO), the International Accounting Standards Board (IASB), the Organisation for Economic Co-operation and Development (OECD), and the World Bank.

Table 2: The insurance industry’s regulatory and supervisory framework is influenced by more than 30 bodies



The Solvency II project is a good example of this. The project is driven by the European Union, but the EU committed to work in coordination with the IAIS. The project is directly or indirectly receiving input from various bodies and individual actors on the international scene. The IAIS issues global insurance principles, standards and guidance papers and the European Commission frequently refers to the work of the IAIS in its papers on Solvency II. The IASB is developing a final reporting standard for insurance contracts. The Solvency II project should be compatible with this standard in order to reach a greater level of harmonisation. This example clearly shows that CEA has to act on all relevant levels at the same time to make sure that the interests of the European industry are taken into account in the development of new regulations.

Besides following international developments bound to influence European insurers' regulation and supervision, CEA is also active in international negotiations for improved access by European insurers to other markets.

On the one hand, this concerns emerging markets such as China, India, Brazil and Russia. The presence of foreign insurers in emerging markets will benefit consumers through increased competitiveness, efficiency and diversity. Talks on the liberalisation of services are being held within WTO and Mercosur. CEA also has direct links with emerging markets related to the EU's neighbouring policy. The Bulgarian Insurance Association (ABZ) has been an associate member of CEA since June 2004. The Romanian (UNSAR) and Ukrainian (LIOU) insurance associations are equally interested in participating in CEA's work.

On the other hand, CEA is closely involved in dialogue with the U.S. and Japan. The U.S. represents the largest non-domestic source of premium income for the European insurance industry. An effective dialogue between the EU and U.S. at international level is crucial since both markets together represent more than 70 per cent of the world insurance market and no major international decision can be taken without their mutual agreement. Convergence between the two regions' accounting standards and corporate governance practices is a key element in the EU-U.S. relationship, as well as ongoing discussions on the reduction of collateral requirements for non-U.S. reinsurers. CEA is also in contact with the Japanese authorities to make sure that in the privatisation of Japan's postal insurance giant, Kampo, which will determine the shape of Japan's life insurance marketplace for the future, all competitors are placed on an equal footing. CEA is contributing to decisions on how and by whom Kampo's successor will be regulated, what taxes it will pay, its participation in policyholder protection arrangements, and whether it will meet Japan's international trade commitments.

Better regulation is necessary for European insurers to fulfil their role in society

The insurance sector plays a key role, both directly and indirectly, in employment and growth. European insurance directly employs over 1 million people. This is remarkable not only because it represents quality employment, but also because the figure has slightly increased over the past few years despite ongoing concentration in the industry and IT-generated productivity increases. In addition to their own staff, insurance companies also involve numerous professionals (intermediaries, experts, repair shops and other suppliers of goods and services related to claims), thus generating a substantial number of further jobs. Insurers' yearly premium revenue amounts to €927 bn and their balance sheet investments total more than €5000 bn. Insurance is a sine qua non for economic growth, job creation and innovation by covering risks inherent in all business development. Finally, it helps governments throughout the world by absorbing the costs of major losses and spreading risks over time and place.

However, a sound regulatory framework is essential to allow for a solid, competitive, innovative European insurance sector which serves the interests of society.

The overall objective of CEA's work is to strike the right balance in regulation between the interests of insurers, their shareholders, consumers, public authorities and other stakeholders. Via CEA, European insurers will pursue dialogue with the EU and international legislators, regulators and supervisors to optimise the industry's competitiveness while addressing its citizens' real concerns.

About the CEA:
CEA is the European insurance federation. Its 32 national member associations cover on average over 93 per cent of their domestic insurance market. More than 5000 European insurance and reinsurance companies are represented by CEA. They generate domestic premium income of 927 bn Euros, employ more than 1 million people and invest over 5000 bn Euros in the economy.
CEA represents the European insurance industry's views to the EU institutions and international regulators and supervisors to ensure an appropriate regulatory framework. It also provides its members with a number of services.

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VI. IAIS COMMITTEE MEETINGS

By Dr Knut Hohlfeld

The IAIS held quarterly committee meetings in February 2005 in Basel and in May 2005 in Beijing. The main purpose of these meetings was the preparation of papers for the IAIS Annual Conference in October 2005 in Vienna and an update of the members and observers of the ongoing work.

The **Emergence Markets Committee** (EMC) held joint meetings with the **Education Subcommittee** and mainly discussed the various training and other educational activities of the IAIS, e.g., executive and regional training seminars, the Core Curriculum Project in cooperation with the World Bank, the translation of IAIS papers into other languages than English, the Insurance Core Principles self-assessment exercise, and the needs and strategy on the IAIS insurance experts list. The IAIS Secretariat (Arup Chaterjee) reported that the IAIS had been approached by the International Labour Organisation (ILO) to cooperate in an envisaged survey on microinsurance, i.e. insurance targeting the low-income population. The survey will be prepared by a consultant. Concerns were raised that special provisions of insurance for low-income groups might not observe prudential regulation rules. It was decided to continue the discussion after the survey has been submitted. In addition, the EMC dealt with the cooperation of the IAIS with other international organisations. On behalf of The Geneva Association I reported that the PROGRES Seminars in November 2004 and April 2005 had been a great success, in particular due to the participation of IAIS representatives, especially several Chairs of IAIS subcommittees.

The **IAIS Solvency and Actuarial Issues Subcommittee** (Solvency Subcommittee) in February 2005 for the first time held a meeting that was partly open to observers. This policy of partly open meetings will be continued for future meetings of the Subcommittee. The open part of the meeting in February (on the first day of the three day meeting) provided a good overview of the current work of the Subcommittee and its ambitious agenda.

The presentation of the draft paper *Towards a common structure and common standards for the assessment of insurer solvency: cornerstones for the formulation of regulatory financial requirements*, was of particular importance. This paper builds upon existing IAIS papers on solvency outlining a more precise view of a number of key elements ("cornerstones") and provides guiding rails for further work on the formulation of regulatory financial requirements. The consultation period for the cornerstones paper ended on 15 April 2005. It is expected that the Subcommittee at its next meeting will prepare a final draft. The paper should be ready for approval at the IAIS General Meeting in October 2005 in Vienna.

The Solvency Subcommittee further is developing a paper providing a roadmap for working towards a common structure and common standards for the assessment of insurer solvency (roadmap paper). It will comprise a range of globally agreed standards and guidelines that can be applied in assessing insurer solvency. These standards and associated guidelines can be used to develop and implement, or serve as a benchmark for, the solvency regime to be applied in a particular jurisdiction as is explained in the cornerstones paper. It is envisaged to finalise the roadmap paper at the next meeting of the Subcommittee. After adoption by the Technical Committee it shall be made public on the IAIS website.

The Solvency Subcommittee is also preparing a paper on asset/liability management. The paper will deal with the subject from the supervisory point of view and cover the whole structure of a company including pricing and product design, assets, in-force liabilities, reporting to management, renewals, etc.

In addition, the Subcommittee is preparing in parallel a supervisory standard on suitable forms of capital and a paper on internal models. It is also considering developing papers on group issues and on market conduct. It will not be easy to cover this ambitious agenda.

The Solvency Subcommittee also heard two interesting presentations. A representative of Fortis, Olav Jones, Chairman of the CEA Solvency II Steering Group, reported on the work of the CEA with regard to the development of a new solvency regime in Europe. The CEA has prepared a comparative study of different existing and suggested solvency models including solvency models of non-European countries. The comparison proved that there are clear differences between the existing European solvency margin concept and the new more risk-based approaches. It further showed that assets and liabilities are not consistently valued in the different geographies and that most recently developed models are based on a Value at Risk approach. Olav Jones also reported on structural/political issues that had emerged in the context of the work of the CEA Solvency II Steering Group, dealt with similarities and differences between Basel II and Solvency II and reported on the increasing industry consensus with regard to a revision of the solvency regime.

A representative of the Swiss Federal Office of Private Insurance explained the new Swiss Solvency Test concept (SST) that, being part of the new insurance supervision act (ISA), will be operational as of 1 January 2006. The basis of the SST is the new Swiss risk-based solvency requirement. Standard models have been developed for asset-liability, life, non-life and health risks. For reinsurance a standard model is regarded as inappropriate. Because of the differences between the reinsurers only internal models should be used. The field test with the standard models for the other areas was successful. Nevertheless internal models can and should be used. But the SST appears doable even for very small companies. The need for an appointed actuary for all life, non-life and reinsurance companies; requirements on corporate governance and risk management; and requirements on groups and conglomerates are other important new provisions of the ISA.

At its meetings in April 2005 in Berlin and in May 2005 in Beijing the **Insurance Contracts Subcommittee** discussed a draft paper entitled *Comments regarding issues arising as a result of the IASB's insurance contracts project – Phase II* providing initial IAIS observations on identified measurement themes common to both financial and regulatory reporting. During the open part of the meeting the IAIS observers got the opportunity to comment on the paper. Prof. Gerry Dickinson commented on behalf of The Geneva Association. The Subcommittee finalised the paper in a closed session. It was then adopted by the Technical Committee and will be sent to the IASB soon. The Subcommittee will continue to prepare input into the IASB throughout Phase II. In particular, as is announced in the comments to the IASB (paragraph 53), it envisages providing further comments on unusual or uncommon products, renewal rights and long-term premium flows, initial and subsequent recognition, and the appropriate treatment of discretionary participation features. It will also closely cooperate with the Solvency Subcommittee.

The **Reinsurance and Other Forms of Risk Transfer Subcommittee** heard several presentations. Alan Spence, Chairman of the Reinsurance Transparency Group, presented the Global Reinsurance Market Report based upon global reinsurance market statistics for the financial year 2003 collected by the Reinsurance Transparency Group.

In his presentation on the changing environment of reinsurance a representative of Swiss Re (Rolf Nebel) described the key role of reinsurers in maintaining a sustainable insurance industry pointing out that nevertheless reinsurers do not pose systemic risks to the real economy. Referring to the many regulatory activities on reinsurance that are currently underway he pleaded for more flexible solvency requirements for reinsurers, emphasising that reinsurers have for a long time used internal risk models as means to calculate economic capital.

Richard Metcalfe representing the International Swaps and Derivatives Association reported on the activities of his Association with the aim to encourage the prudent and efficient development of the privately negotiated derivatives business.

Stephen Schwab (DLA Piper Rudnick Gray Cary) who represented the International Bar Association to the Hague Convention on Exclusive Choice of Court Agreements gave an update of the work on the Hague Convention. He appreciated the fact that the UK and the European Commission now supported the U.S.-proposed amendments to the draft Convention dealing with the enforceability of judgements with respect to insurance and reinsurance contracts. He expressed his hope that other jurisdictions would follow. The issue will be dealt with at a Diplomatic Conference in June 2005.

A representative of the European Commission (Ulf Linder) gave an update of the work on the EU reinsurance directive. Most of the IAIS reinsurance principles and standards are covered by the directive while some more will be dealt with at the Solvency II process. With regard to the solvency requirements, for non-life as well as for life reinsurance, in principle, they correspond to the solvency requirements for non-life primary insurers. One of the aims of the reinsurance directive is to make collateral requirements unnecessary.

At its May meeting the Subcommittee also discussed the first draft of a guidance paper on finite risk reinsurance. The IAIS Secretariat drafted a survey that included 21 questions that had to be replied to by 10 June 2005. A revised draft would be prepared by end-June 2005 followed by a two-month consultation period for IAIS members and observers. After considering the comments received the paper would then be finalised to be approved at the IAIS General Meeting in October 2005 in Vienna.

The **Reinsurance Mutual Recognition Subgroup** finalised its work plan. It decided to focus the initial work on the issues identified in the work plan under regulatory requirements. The topics in this respect were allocated to six teams which inventoried current related IAIS work, identified critical issues that are important for mutual recognition of reinsurance supervision, and identified the areas where additional work is needed. They further prepared questions for a survey on items where additional research is deemed necessary. The IAIS Secretariat will send a revised compilation of the questions to the members of the Subcommittee asking for responses by end-August 2005.

At its February meeting the **Enhanced Disclosure Subcommittee** discussed a revised draft entitled *Standard on disclosures concerning investment performance and risks for insurers and reinsurers*. A CEA representative (Hervé Votron) and (speaking on behalf of seven insurance associations from Austria, Germany, Japan and the U.S.) a representative of the German Insurance Association (Hans-Jürgen Saeglitz) gave presentations on their positions on the draft standard. The CEA in particular expressed concerns for the enormous amount of information demanded and duplications with other reporting duties. The disclosure requirements should be based on IAS/IFRS, disclosures should be presented at a group level rather than at the level of individual companies, and obligatory public disclosure of qualitative information about investment objectives, policy and management should be restricted to general information whereas the supervisors might ask for complementary detailed information. Also Mr Saeglitz warned against extensive disclosure requirements that would overburden the insurance companies. Not only benefits but also the costs of extended disclosure should be taken into account. Mr Saeglitz advocated minimum requirements on disclosure that should not be as prescriptive as envisaged in the annexes of the current draft standard. Further details were addressed in the following discussion such as the target audience of disclosure and the release of proprietary information. The discussion was continued and compromises achieved at further meetings in April and May 2005. The IAIS Technical Committee adopted the draft standard at its meeting in May 2005 in Beijing. It will be presented to the IAIS General Meeting in October 2005 in Vienna for approval.

The **Insurance Fraud Subcommittee** (IFS) discussed the draft *Guidance paper on combating the misuse of insurance companies for illicit purposes*. Such misuse for illegal purposes could take place by taking control of the insurance company, by infiltration of the board or management, or by transactions with related parties. The paper is intended to provide guidance to supervisors on how to deal with this. It has been circulated to all IAIS members and observers for comments by 14 June 2005. The IFS further discussed the proposed updating of the *Guidance paper for fit and proper principles and their application* (October 2000) and its upgrading to a supervisory standard (*Supervisory Standard on fit and proper requirements and assessment for insurers*). It was pointed out that the list of information required for the purpose of security and financial vetting of an individual should not be too detailed and that the confidentiality rules had to be taken into account. It was also proposed to envisage a more risk-based approach for fit and proper testing. The draft paper has been circulated to all IAIS members and observers for comments by 14 June 2005. The Subcommittee will deal with the comments on both papers at a meeting at the end of June 2005. The papers should be finalised in time to be approved at the IAIS General Meeting in October 2005 in Vienna. In addition the IFS is developing a *Guidance paper on fraud on insurers* differentiating between claims fraud, internal fraud by staff, and intermediary fraud. This paper should be finalised for approval at the IAIS General Meeting in October 2006 in Beijing. At its May meeting in Beijing the IFS further discussed the contents of a report to the FATF June 2005 plenary meeting on AML/CFT activities. It also accepted the invitation of the International Criminal Police Organisation (Interpol) to participate in its Working Group on Money Laundering and Terrorist Financing (as an observer). The Chairman of the IFS will participate in a conference on "Combating economic crime" organised jointly by the Council of Europe and the Ministry of Justice of Portugal.

The **Financial Conglomerates Subcommittee** heard presentations on

- how ING, a worldwide active financial conglomerate, deals with insurance risk management;
- the new structure of supervision of the financial sector in the Netherlands;
- regulation and bancassurance in Brazil; and
- how the Financial Supervisory Agency of Japan deals with cross-sector issues.

The Subcommittee also discussed the draft paper entitled *Assessing the IAIS's efforts in promoting cross-border and cross-sector cooperation and information exchange*. The paper consists of three parts. It identifies the IAIS Principles, Standards and Guidance Papers that deal with cross-border and cross-sector cooperation and information exchange, analyses the adequacy of these standards, and recommends future work in areas where improvement may be required. The discussion especially concerned confidentiality issues. The paper was finalised at the May meeting in Beijing and then adopted by the Technical Committee.

The **Task Force on the Assessment and Implementation of the Insurance Core Principles** discussed first findings from the Insurance Core Principles (ICP) self-assessment exercise 2004. Fifty-five out of 118 member jurisdictions had so far submitted their self-assessments. All IAIS members that had not yet completed their self-assessments were encouraged to do so. A small group was set up that will summarise and analyse the results of the self-assessment exercise. First findings show that gaps and weaknesses in the observance of the ICPs in particular concern the ICPs 9 (corporate governance), 17 (group-wide supervision), 18 (risk assessment management), 22 (derivatives and similar commitments), and 27 (fraud). The small group will finalise its report in time to be presented to the IAIS General Meeting in October 2005 in Vienna.

The **Task Force on the Core Curriculum** is making good progress in developing a comprehensive learning curriculum for insurance supervisors based on the Insurance Core Principles and the additional IAIS principles, standards and guidance papers. However, the Task Force is still looking for authors and reviewers for a few remaining modules. Fifty-six learning modules are planned over a three year period, 2004-2006. The Core Curriculum modules are jointly produced by the IAIS, the World Bank and regional partners to provide non-commercial materials for supervisors. More than 20 high quality training modules have already been completed. The IAIS is preparing to open the access to the learning tool on a new Core Curriculum section on the IAIS website. It will be available to all IAIS members and observers that sign the Core Curriculum Terms of Use. Mr Patrick Liedtke, Secretary General of The Geneva Association, signed the Terms of Use on behalf of The Geneva Association. The Geneva Association will therefore have access to the new website section from the start.

Author: Dr Knut Hohlfeld heads The Geneva Association's PROGRES Research Programme as its Director.

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VII. 21ST PROGRES INTERNATIONAL SEMINAR: THE REGULATION AND SUPERVISION OF FINANCIAL ISSUES—CHALLENGING ISSUES

By Dr Knut Hohlfeld

The 21st PROGRES International Seminar was held on 7-8 April 2005 in Geneva under the theme "The Regulation and Supervision of Financial Services: Challenging Issues". The Seminar in particular focused on Solvency II, the Insurance Core Principles, anti-money laundering, terrorism and insurance, and WTO/GATS and financial services liberalisation.

After an introduction by Patrick Liedtke, Secretary General of The Geneva Association, who emphasised the importance of good cooperation of the banking and insurance sectors, the Secretary General of the Basel Committee on Banking Supervision (BCBS), Ryozo Himino, gave an opening address on the evolution of bank capital adequacy frameworks. He outlined the history of the BCBS, the 1988 Basel Capital Accord (Basel I) and the development of the Core Principles issued in 1997. Basel II, the new capital accord to be implemented by 2007, has been developed in response to the globalisation of the financial markets. While Basel I was mainly driven by regulators Basel II is more driven by the industry. The banks may use internal models for the risk measurement and management. The supervisory regime will change from compliance-based supervision to risk-based supervision. The implementation of the new system will not be easy. Basel II refrains from too detailed rules in order to avoid too many restrictions. The new system is intended to be evolutionary and dynamic, based on more dialogue and more disclosure.

There were four speakers in the first session: Christopher McHale, member of the Joint Forum, Yoshihiro Kawai, Secretary General of the IAIS, Christian Pierotti, Manager at the CEA, and David Schraa, Director at the Institute of International Finance (IIF). They reported on new developments in the activities of their respective organisations. The Joint Forum is a working group established in 1996 under the aegis of the BCBS, IOSCO (International Organisation of Securities Commissions) and the IAIS and consists of an equal number of representatives of these three international organisations. It deals with issues common to at least two of the three financial sectors, banking, securities and insurance. The most recently published reports deal with outsourcing in financial services (February 2005) and credit risk transfer (March 2005). The Joint Forum is currently working on reports on liquidity/funding risk, contingency planning and market differences. Mr Kawai reported that the IAIS at present is preparing a framework for insurance supervision that brings together the substantial amount of work that the IAIS has already undertaken and provides structure in identifying key subjects for future IAIS work. As a next step the IAIS is developing cornerstones for the assessment of insurers' solvency. For the time being the goal is not to harmonise capital requirements or prudential levels, but to make the components transparent and comparable. According to Mr Pierotti the work of the CEA is strongly influenced by the enlargement of the EU and the many international regulatory initiatives. Mr Schraa explained that the main topic of the IIF is macro-economic analysis. It works on the conditions for crises interventions and on crises solutions and supports the improvement of investor relations in emerging market economies. The IIF is further working on corporate governance and welcomes the new working group of the BCBS on corporate governance. Mr Schraa also urged more supervisory transparency and mentioned that the home/host issue remained a major problem. The IIF is in favour of changing the whole culture and of more trust amongst supervisors.

The second session dealt with the Solvency II project of the European Commission. Karel Van Hulle, the head of the Insurance Unit of the European Commission, explained the background and objectives of the project emphasising that Solvency II was more complicated than Basel II. The goal is a risk-oriented approach for capital requirements based not only on quantitative but also on qualitative criteria. The insurers should be able to manage their own risks using internal models for their risk management that would have to be approved by the supervisory authority. The Solvency II directive is intended to be a framework directive focusing rather on principles than on detailed rules. The first proposal for a directive should be ready by the end of 2005 and the final draft by April 2006. Its adoption can be expected in October 2006 at the earliest. Consequently almost all decisions could be taken between now and the end of this year. Comments are therefore urgently needed although there will be a long transition period since, as Mr Van Hulle mentioned, the directive might enter into force probably not before 2010. Mr Van Hulle's presentation was followed by those of two representatives of the insurance industry on implications of the Solvency II project for the insurance industry. They both supported the new risk-based solvency approach. Michael Koller (Swiss Re) strongly advocated the full allowance of internal risk models and processes, stressing that the insurance companies had to strengthen their risk management processes and capabilities. He designated an open risk culture and general risk transparency as key for risk management to be effective and credible and a meaningful risk disclosure to all stakeholders as necessary. Philippe Trainar (Federation of French Insurance Companies, FFSA) emphasised that the solvency requirements have to differentiate between anticipated and unanticipated shocks. Capital is needed for absorbing unanticipated shocks, whereas anticipated shocks should be covered by the technical provisions. Mr Trainar advocated a proportional approach of supervision. Control should be proportional to margin level. Above a certain level, supervisory power should be strictly limited since the interest of the company and the consumers would optimally converge. Should the solvency fall below a certain minimum, extensive supervisory power would become necessary. Between these two extremes the supervisory power should increase progressively. Mr Trainar further stressed that the solvency reform should be used to end the current fragmentation of the EU insurance "single" market due to supervision practices. The Solvency II directive should not only harmonise the rules throughout Europe, but it should also promote a coordinated implementation based on clear and constraining procedures.

The following session dealt with the Insurance Core Principles. Helmut Müller, former President of the German Insurance Supervisory Office, gave an overview of the contents of the 28 Insurance Core Principles adopted by the IAIS in 2003. They address nearly all areas of insurance supervision and form the basis for effective supervision of insurance and reinsurance. Craig Thorburn (World Bank) spoke about the purpose and results of the Financial Sector Assessment Programme (FSAP) that has been jointly launched by the IMF and World Bank. According to this programme the supervisory regimes worldwide are assessed, in particular to what extent they comply with the Core Principles developed by the BCBS, IOSCO and IAIS. The assessments of about 100 jurisdictions have so far been completed, of which about 70 included the insurance sector. Regulatory gaps often referred to corporate governance, solvency/liabilities regulation, fit and proper reach, change of control oversight, and the supervisory independence (different from banking supervision, insurance supervision in many countries is part of the ministry of finance). Supervisory authorities often are underresourced and lack sufficient expertise. Edward Forshaw (FSA UK) reported that the assessment of the FSA UK under the FSAP required a great deal of preparatory work, time and personnel but that this was well spent taking the lessons learned from the assessment.

A further session dealt with money laundering in the insurance sector. Peter van den Broeke, Chairman of the IAIS Insurance Fraud Subcommittee, reported on the IAIS activities with regard to anti-money laundering and combating the financing of terrorism. He in particular referred to the *Guidance paper on anti-money laundering and combating the financing of terrorism* issued by the IAIS in 2004 which builds upon the 40 + 9 FATF recommendations and provides insurance specific guidance. Currently the IAIS is developing guidance papers on the prevention of misuse of insurers for illicit purposes and on fraud on insurers, providing guidance on anti-fraud policy, measures and procedures differentiating between claims fraud, intermediary fraud and internal fraud. Georges Stansfield, General Counsel of the AXA Group, reported on combating money laundering and terrorist financing risks in the life insurance industry. He especially mentioned that life insurers, their employees and agents need to be sensitive to certain "red flags" that may be indicators of risk: Purchase of single-premium life insurance policies or annuities with large amounts of cash, money orders, travellers' checks or other bearer instruments; purchase of insurance or annuity contracts in amounts beyond the owner's apparent needs; unusual surrender activity without regard to penalties; unusual relationships with an intermediary; and unusual payments to an intermediary. Andy Wragg (Lloyd's) dealt with the challenges facing non-life insurers from money laundering (see his article in this Newsletter).

At the session on terrorism and insurance, three representatives of the insurance industry spoke about terrorism insurance in their respective countries. Christopher Yaure, General Electric Insurance Solutions, described the U.S. approach to insurance against terrorism. Terrorism is covered in workers' compensation insurance and personal lines insurance. In commercial property insurance and general liability insurance, the insurance of terrorism is excluded. The Terrorism Risk Insurance Act of 2002 (TRIA) introduced a temporary programme of shared public and private compensation for insured losses resulting from acts of terrorism characterised by mandatory availability; federal compensation (90 per cent of insured losses in excess of a deductible); cap on liability (aggregate losses $ 5 mio or less; $ 100 bn maximum aggregate industry losses in one year); certification process (an act of terrorism has to be certified by the Secretary of Treasury); and recoupments and surcharges. The programme expires on 31 December 2005. It is still an open question whether it will be replaced by a new or similar programme. Bruno Gas, Chief Executive of EXTREMUS Versicherungs AG, presented the German terrorism insurance solution. In the aftermath of September 11 the German federal government agreed to act as "insurer of last resort" with regard to the risk of terrorism as far as large property risks are involved, on the condition that commercial insurance and reinsurance markets would grant a primary layer of insurance cover of € 3 bn (now reduced to € 2 bn). In turn, the cover offered by the government comprises a secondary layer of up to € 10 bn (now reduced to € 8 bn). As a result 16 insurers and reinsurers active in the German market founded a special insurance company called EXTREMUS. Its sole purpose is to insure large property risks against terrorism, each with an insurance sum of more than € 25 mn. The annual maximum indemnity for each client is limited to € 1.5 bn. The risks assumed by EXTREMUS are 100 per cent reinsured. This kind of public-private partnership in terrorism insurance is due to cease on 31 December 2005. But it is hoped that the German government will agree to continue the model. Steve Atkins, Chief Executive of Pool Reinsurance Company Limited, explained terrorism coverage in the UK. Pool Re is a reinsurer that covers unlimited damage to commercial property in Great Britain and consequential business interruption and offers membership to all suitably authorised insurers which insure property located in Great Britain. The members have to cede all terrorism cover they provide to Pool Re. The UK Treasury guarantees to provide funding to Pool Re if needed, subject to repayment by Pool Re. It receives a premium for this cover and certifies losses as an Act of Terrorism.

In a further session, Christian Pierotti, CEA, stressed the need for close cooperation of the EU and the USA as the key players in the globalised insurance market. The aim should be more liberalisation. He demanded a more proactive dialogue on regulation and legislation, more pre-consultation on future legislation and wider participation and involvement of the insurance industry. Rolf Nebel, Swiss RE, pleaded for less regulation. As regards the supervision of reinsurers, in his view indirect supervision ensured the supervisory goal of policyholder protection. Direct supervision of reinsurers should be restricted to only a few tools such as licensing, corporate governance and ownership, disclosure requirements, technical provisions (qualitative review) and solvency (economic capital concept). Stefan Engelländer, KPMG, gave an overview of the IASB insurance accounting project. A final standard on insurance contracts cannot be expected before mid-2008 with a first discussion paper not before the end of 2005 and an exposure draft at the earliest mid-2007. John Cooke, consultant and member of the Financial Leaders Working Group Insurance Team, reported on a study that he is currently preparing on inefficiencies in the EU and U.S. insurance and reinsurance markets, on the costs of inefficiencies and the benefits to be derived from reducing them. He mentioned, as one of the provisional results, that the EU and the USA, both suffer imperfections and intra-market barriers resulting from regulatory fragmentation. As regards credit for reinsurance, the study suggests that the collaterisation requirements, that form part of the U.S. and also the French credit for reinsurance regime, are cumbersome, inconvenient, discriminatory and a barrier to business.

The last session dealt with the GATS negotiations and financial services liberalisation. In his opening speech Ambassador Alejandro Jara from the Permanent Representation of Chile to the WTO, who is also Chairman of the Special Session of the GATS Council, was quite optimistic with regard to a resumption of the GATS negotiations on financial services, but recommended increased pressure from outside, particularly from the financial industry. Kurt Schneiter, Member of the Board of the Swiss Federal Office for Private Insurance and Chairman of the Insurance and Private Pensions Committee of the OECD, strongly advocated further liberalisation of insurance services. Liberalisation should be backed by its cornerstones: Reliance on the effectiveness of the international standards; promotion of customers' education; pressure by the market on the insurance companies to enhance their transparency; supervisory power to grant and to withdraw a licence from insurers and reinsurers; and binding cooperation agreements between supervisors. Regulatory measures should be critically scrutinised since, as Kurt Schneiter stressed, it is the market that knows how to recover, to grow and to improve, not the governments, not the supervisors and not the parliaments. Jürgen Huppenbauer from the German Insurance Association referred to the model schedule prepared by the Financial Leaders Working Group and recommended by insurance associations of Canada, the EU, Japan and the USA. The model schedule is intended to serve as a guideline for scheduling liberalisation commitments, a checklist for scheduled commitments, a benchmark for assessing supervisory systems and as a background paper for discussions with trade negotiators, insurance regulators and supervisors, and governments. According to Mr Huppenbauer, the liberalisation of insurance services can be achieved more easily by using this model schedule. Ms Miyon Lee, Permanent Mission of South Korea to the WTO and Chair of the Committee on Trade in Financial Services reported on latest developments in trade in financial services. There was only little improvement and not much progress. Ms Lee emphasised that it really should now be time to utilise the Committee on Trade in Financial Services, which is the only sector-specific committee, and as it has a broad mandate. Ms Nora Dihel from the OECD Trade Directorate gave a presentation on assessing the restrictiveness of barriers to trade in banking services. She was critical of the methods for measuring the barriers and proposed several improvements to the measurement methods. Ms Lamia Fakhry, from the Permanent Mission of Egypt to the WTO, reported positively on the experience of the liberalisation of financial services in Egypt. In his report on negotiations on possible disciplines of domestic regulation affecting trade in services, Johannes Bernabe, from the Philippine Mission to the WTO, was quite optimistic that regulation, probably covering all sectors, could be included as discipline for negotiations. Peter Morrison, legal counsellor of the WTO Trade in Services Division, came to the conclusion that from the past WTO dispute panel decisions, lessons can be drawn for financial services, even though no cases in financial services have yet been decided. The past WTO dispute panel decisions have, however, given a broad interpretation of the GATS provisions that would also be relevant for disputes in financial services.

The next PROGRES International Seminar is scheduled for 30 and 31 March 2006.

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VIII. CHINA INTERNATIONAL INSURANCE FORUM: BUILDING UP A MODERN INSURANCE SUPERVISORY SYSTEM

By Dr Knut Hohlfeld

The China Insurance Regulatory Commission (CIRC) organised a senior level International Insurance Forum that was held on 23 May 2005 in Beijing. 130 international and 150 Chinese insurance supervisors, insurance industry representatives and academics attended the Forum. In his opening speech the Chairman of the CIRC, Mr WU Dingfu, gave an overview of the rapidly growing Chinese insurance market and mentioned that China was modernising its regulatory system. The Deputy Governor of the People's Bank of China (PBOC), Ms WU Xiaoling, emphasised the good cooperation between the PBOC and the CIRC. Mr JIANG Zhenghua, Vice President of the National People's Congress, referred to the persistent strong growth of the Chinese economy and stressed that China is developing a harmonious society based on socialist democracy. He mentioned insurance as an irreplaceable role for building the harmonious society.

Mr Michel Flamée, Vice Chairman of the Belgian Banking, Financial and Insurance Commission and Vice Chairman of the IAIS, called the home country control system in the EU still a challenge and went into the establishment of an integrated supervisory structure covering the supervision of all financial sectors using Belgium as an example.

Mr Tom Karp, Executive General Manager Diversified Institutions of the Australian Prudential Regulation Authority (APRA) and Chairman of the IAIS Technical Committee, talked about modern insurance supervision system construction and described the IAIS structure and the process of setting international standards for insurance supervision. Reporting on the IAIS activities he emphasised, in particular, the importance of the Insurance Core Principles issued in 2003 and the framework for insurance supervision that recently has been developed making clear the structure and also interlinkages of the IAIS principles, standards and guidance papers.

Ms Diane Koken, Insurance Commissioner of the State of Pennsylvania and President of the NAIC, referred to the state regulated insurance supervisory regime in the U.S. and stressed the supporting and coordinating role of the NAIC.

Mr Kurt Schneiter, Member of the Board of the Swiss Federal Office for Private Insurance and Chairman of the Insurance and Private Pensions Committee of the OECD, described the activities of the OECD in the area of insurance and private pensions and the usefulness especially for emerging economies.

Dr Chang-Lok Kim, Deputy Governor of the Financial Supervisory Commission and the Financial Supervisory Service of Korea, gave an overview of the restructuring of the Korean financial supervisory system in the aftermath of the Asian financial crisis in 1997 and the establishment of an integrated financial supervisory authority. In his view, financial regulators' top priority should be financial stability.

The Deputy Commissioner of the Japanese Financial Services Agency, Mr Toru Shikibu, explained the newly launched "Programme for further financial reform" aiming at bringing vitality into the Japanese financial system through the efforts of the private sector; enhancement of convenience of financial service users; protecting users; improved governance and advanced risk management; and reliable, transparent and accountable financial supervision.

These presentations by representatives of the regulatory and supervisory community were followed by five presentations of top level representatives of the insurance industry. Mr TANG Yunxiang, President of PICC Holding Ltd, strongly pleaded for a modernisation of the Chinese insurance regulation system in order to promote quality and efficiency of the rapidly growing Chinese insurance industry.

Mr Sergio Balbinot, CEO of Generali Insurance, spoke about the interplay between regulators/supervisors and the insurance industry. He stressed the change in the state of affairs between regulators and the supervised industry that for today he described as being one of convergence, cooperation and partnership and, as a corollary, mutual trust. He especially pointed out the importance of clear, effective and efficient legislation. In this context he praised the engagement of the IAIS in setting common global standards and principles on insurance and insurance supervision, which being implemented in local jurisdictions could contribute to deliver the necessary level of effectiveness and efficiency of legislation.

Mr ZHANG Zixin, CEO of PingAn Insurance Company, underlined the important role of insurance companies as institutional investors in pursuit of long term return and advocated a broadening of insurance investment opportunities.

In his speech on self-discipline of the players in the construction of an insurance regulatory system Mr WANG Xianzhang, President of the China Life, claimed that regulation should take solvency at its core and that a sound corporate governance system was the base of an effective regulatory system. He further emphasised the important role of insurance associations in promoting self-discipline of the industry.

In his presentation Mr Karl Wittmann, Member of the Board of Munich Re, stressed the importance of integrated risk management for insurers and reinsurers. He appealed to the CIRC and the Chinese insurance industry to put integrated risk management as a top priority on their agenda in order to secure a stable, sustainable and successful steering of their corporations and thus to attract all stakeholders concerned. Mr Wittmann further spoke in favour of a globally coordinated supervisory system with centralised supervision of reinsurance companies by the home state supervisory authority.

The Forum concluded with presentations by two academics. Mr Gerry Dickinson, Professor at the Sir John Cass City of London Business School, mentioned, in his presentation on the economic considerations in designing a modern regulatory and supervisory system for insurance, that regulation and supervision often need to be more restrictive in emerging insurance economies in part to ensure that there is a sound foundation for the future development of the domestic insurance market. He further pointed out that the scope of supervision has widened in recent years and that insurance also has the potential of macro-economic effects. A modern supervisory regime is characterised by a shift from operational controls to financial control. The supervisor should understand strategies, operations and risks of insurance companies. The convergence between banking, insurance and securities requires an adequate cross-sector sharing of information and effective cooperation in the supervision of complex financial services enterprises. Prof Dickinson does, however, not see a compelling economic reason for a country to follow the growing international trend towards a single supervisory authority for the three financial sectors.

Mr LI Yang, Professor on economics, stressed that corporate governance is an issue that is not only applicable to the industry but also to supervisors. Supervisors must be independent, i.e., in particular free from political influence by the government. They also have to be accountable. They should always give clear and reasonable arguments and explanations for their decisions. The transparency of decisions should be comprehensive. Everybody should have access to the information.

Mr WU Xiaoping, Vice Chairman of the CIRC, thanked all participants, in particular the presenters, and closed the Forum. This ended an event with many interesting presentations.

Author: Dr Knut Hohlfeld heads The Geneva Association's PROGRES Research Programme as its Director.

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IX. CONFERENCES ORGANISED AND/OR SPONSORED BY THE GENEVA ASSOCIATION

2005

June		
1-4	**Paris (Versailles)**	**32nd General Assembly of The Geneva Association** (members only) hosted by the French members
16-17	**Berlin**	**11th joint seminar of the European Association of Law and Economics (EALE)** and the Geneva Association
August		
7-11	**Salt Lake City**	**1st World Risk and Insurance Economics Congress**, jointly organised by The Geneva Association, ARIA, APRIA and EGRIE
September		
30	**St Gallen**	Two sessions organised at **1st Viva 50 plus World Ageing & Generation Congress** "The future of Pensions" and "Working beyond 60: Key Policies & Practices in Europe".
October		
3-4	**Brussels**	**3rd Annual Roundtable of Chief Risk Officers**, hosted by Fortis
14	**Rome**	**Montepaschi Vita Annual Forum**, organised by Montepaschi Vita and The Geneva Association
23	**Chicago**	"Global Reinsurance Forum" session supported by The Geneva Association at the **PCI Annual Meeting**
26-28	**Munich**	**2nd Liability Regimes Conference**, hosted by Munich Re
November		
tba	tba	**20th MORE** (Management of Risks in the Economy) Conference
11-12	**London**	**2nd Geneva Association Insurance and Finance Conference**
14	**Brussels**	**Solvency II Conference,** co-organised with CEA
22	**Milan**	**Solvency II** organised with Macros
24	**Munich**	**Longevity—A Medical and Actuarial Challenge Conference,** organised by GE Frankona and The Geneva Association
December		
8-9	**Paris**	**3rd Meeting of the Global Insurance Communications Network,** hosted by AXA Group
13	**Paris**	**4th Paris International Insurance Conference,** co-organised with the FFSA

2006

January		
10	**New York**	**Joint Industry Forum**
February		
2-3	**Amsterdam**	**8th Meeting of the Geneva Association's Amsterdam Circle of Chief Economists (ACCE),** hosted by ING
March		
30-31	**Geneva**	**22nd PROGRES Seminar**