

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS



SUPERVISORY STANDARD ON ON-SITE INSPECTIONS

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Supervisory Standard on On-site Inspections

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1. Introduction

1. The objective of insurance and reinsurance supervision is to protect policyholders and policy beneficiaries. To achieve this objective, Supervisory Authorities should elaborate supervision methods, which include the ability to conduct on-site inspections.

2. On-site inspection, whether by the supervisory authority or its representatives, is a vitally important part of the supervisory process, closely related to the on-going monitoring process. On the one hand, it provides information that supplements the analysis of the financial and statistical information sent by the insurance or reinsurance company. On the other hand, on-site inspection needs the support of market information and statistics deriving from the analysis of the annual accounts and returns.

3. On-site inspection is an important way to verify or capture reliable data and information in order to assess a company's current and prospective solvency, measuring its evolution and the reasons for this evolution.

4. But the usefulness of on-site supervision is not strictly limited to that point.

5. On-site inspection enables the supervisor to obtain information and detect problems that cannot be obtained or detected through on-going monitoring. In particular:

- a. in the case of companies experiencing asset trouble, accounting irregularities or deficient management, it enables the supervisor to identify problems that the company could be given to ignore and, sometime, to hide;

- b. it offers supervisors the opportunity to have a personal relationship with the managers, which is very valuable to assess their fitness and properness;
 - c. it enables supervisors to assess the management's decision-making processes and internal controls;
 - d. it can dissuade companies from pursuing activities, which are either illegal or improper;
 - e. it provides supervisors the opportunity to analyse the impact of specific regulations and, more generally, to gather information for benchmarking.
6. On-site inspection is also of great assistance in dealing with companies' problems. For example, the supervisors:
- a. may be able to persuade the companies' management to take action to avoid current or future problems through dialogue during on-site inspection, which may be more efficient than through regulations;
 - b. can use on-site inspections as an opportunity to provide companies' management with information, especially concerning new legislation which might need to be explained in order to avoid misinterpretation.
7. The purpose of this paper is to provide insurance supervisors with some general supervisory standards for the conduct of on-site inspections. It is divided into three main parts:
- a. most important objectives of on-site inspections;
 - b. description of the on-site inspection procedure;
 - c. organisation of the on-site inspection process.

2. Definitions

8. The following definitions apply to terms used in the paper:

Board of Directors refers to either the board of directors of a company which is incorporated in the jurisdiction or, in the case of a company which is incorporated in another jurisdiction and which is licensed in the jurisdiction, to a senior company official, acceptable to the insurance supervisor.

Financial Reports refer to accounting statements, financial returns and statutory reports, including the balance sheet and the income statement and any other numerical reports prepared for disclosure to policyholders, investors or insurance supervisors and do not refer to reports prepared for other purposes.

Insurance Company refers to a licensed legal entity, which underwrites insurance.

Insurance or Reinsurance Supervisor refers to the insurance supervisor in the jurisdiction.

Reinsurance Company refers to a legal entity, which underwrites only reinsurance.

3. Most Important Objectives of On-site Inspections

9. Generally speaking, the key objective of any on-site inspection is the appraisal of the company's current and prospective solvency. More specifically, the objective is to compare the risk profile of the company with its risk-carrying capacity and to detect any problem that may affect the company's capacity to meet its obligations towards policyholders in the long term.

10. However, on-site inspection should not be limited to detecting the company's problems. Supervisors should also delve into the reasons behind them and identify solutions to overcome them.

11. These objectives can be split into intermediate objectives:

- a. to appraise the assets and liabilities (including off balance sheet commitments) and to analyse the adequacy of tariffs and the balance of operations;
- b. to evaluate the technical conduct of the insurance business (e.g. actuarial methods, commercial policy, reinsurance policy);
- c. to evaluate the treatment of customers and to determine whether unlawful or improper activities are engaged in at the expense of policyholders or public interests;
- d. to assess the accounting and internal control systems, and to form an opinion on the corporate governance;
- e. to detect problems that may arise from the company's organisation or its belonging to a group.

4. The On-site Inspection Procedure

4.1 Planning and preparation

12. Following the analysis of the financial and statistical information sent by the companies, the supervisor should develop a program, based upon a systematic analysis of the records of the company, for the on-site inspections which are to be carried out in the next months.

13. This plan will take into account on the average frequency of on-site inspections and the companies' risk profile. On-site inspections are more frequent and more in depth when they concern companies which are in a difficult economic or financial position. However, a major change in the top management or in the objectives and business plan of the company might be a sufficient reason for a new on-site inspection.

14. Nevertheless, the on-site inspection plan should remain indicative since new priorities might arise during the year. Besides, the length of the inspections is not predictable: the actual on-site inspection may take anything from one day to several months depending on the business of the company, its size, and above all on the problems met.

15. In this respect, an on-site inspection should begin with an overview of the company in order to properly plan and focus the fieldwork. This review should be pursued with the managers and result in an agenda of the fieldwork to be made.

4.2 Fieldwork

16. While on-going monitoring can be systematic and to a certain extent standardised (analysis of the consistency of financial statements, position of the company with respect to the average of the market), on-site inspection is customised and suited to the company's particulars, and to the problems detected on site. Thus, it is difficult to determine in advance the length and exact outlines of on-site inspections. Besides, an on-site inspection can either be a full-scale inspection or a partial one.

17. Where supervisors undertake a full-scale on-site inspection this one should include at least the activities listed below.

18. However, in case of an inspection concentrated on a limited area of specific concern, the supervisor could take into account only the relevant points among them. Besides, some of these activities can be conducted off site.

a. Evaluation of the management and internal control system

- reading of the minutes of the meetings of the Board of Directors, the auditors' reports and, if any, actuaries' and electronic data processing audits;
- analysis of the ownership structure and sources of capital funds;
- evaluation of the fitness and properness of the management, their efficiency, and their ability to acknowledge and correct their management mistakes (especially after changes in the composition of the board);
- examination of all the company's current internal procedures and risk control systems in order to assess the relevance of these internal controls and the company's approach to risk management;
- examination of the accounting procedures in order to know whether the financial and statistical information periodically sent to the supervisory authority is trustworthy or not, and in compliance with the regulations.

b. Analysis of the company's activity

- analysis of the major categories of business, the customers and the geographical spread thereof;

- examination of the business plans and meeting with the management to get information about the plans for the future;
 - analysis of the contracts.
- c. Evaluation of the technical conduct of insurance business
- evaluation of the organisation and the management of the company;
 - analysis of the commercial policy of the company: in particular, policy conditions and commissions paid to the intermediaries;
 - evaluation of the reinsurance cover and its security: in particular, the reinsurance cover should be appropriate to with the financial means of the company and the risks it covers.
- d. Analysis of the relationships with external entities
- analysis of the organisational charts, the group structures and the intragroup links;
 - analysis of the relationships with branches abroad and the intragroup transactions;
 - analysis of agreements with external service providers;
 - identification of any financial problems originating from any entity in the group to which the company belongs.
- e. Evaluation of the company's financial strength
- analysis of the settlement of claims and the calculation of the technical provisions according to current regulations;
 - analysis of the adequacy of tariffs and the balance of operations;
 - analysis of the investment policy (including derivatives policy), the assets held to cover the technical provisions;
 - verification of property and valuation of the company's investments;
 - analysis of the litigation and off balance sheet commitments;
 - analysis of the forecasted balance sheets and profit & loss accounts of the next two or three years, on the basis of the most recent results and the management plans.
19. Where supervisors have the necessary powers to deal with the treatment of the customers, they may include the following points in the on-site inspection:
- a. review of the information given to customers and checking of its sufficiency and adequacy;
 - b. review of the time for payment, the number and nature of litigation and the transactions with the policyholders;
 - c. assessment of the compliance with the consumer regulations.

4.3 Assessment and reporting

20. During, or at least at the end of this inspection, the supervisor should discuss findings with the insurance company and should pay adequate attention to its reaction.
21. Supervisors should follow up to ensure corrective action, when identified, has been acted upon.

5. Organisation of the On-site Inspection Process

22. On-site inspection should have a legal basis in order to sustain the right of the supervisor to obtain any information. Insurance legislation should give the Supervisory Authority wide-ranging powers to investigate insurance or reinsurance companies, and to gather any kind of information.
23. Furthermore, the supervisor should have the power, where appropriate, to extend on-site inspections to brokers and companies that have capital links with, or that have accepted functions outsourced by, the supervised company.
24. The Supervisory authorities should organise the process of on-site inspections in order to maximise their efficiency. By doing so, they should consider, among other matters, the allocation of supervisory tasks between supervisors and they may wish to outsource certain parts of the inspection.
25. Some supervisory organisations may have responsibility for both on-going monitoring and on-site inspections for a group of companies. This type of organisation provides close relation between the monitoring and on-site inspection. It also appears to be an efficient way to follow through companies during a long period of time. However, it needs officers dealing with all the aspects of insurance supervision (e.g. accounting, actuarial methods, finance, data processing) and all types of insurance (e.g. health, vehicle, liability).
26. Some supervisory organisations may have specialists in some tasks or in some types of insurance and take part in the on-site inspection of a great number of companies. This type of organisation appears to be flexible and efficient to deal with market problems. However, a good co-operation and exchange of information is needed between officers in charge of monitoring and those in charge of on-site inspection. Accordingly, results of analyses must be documented and accessible to both groups.
27. Whatever the internal organisation of the supervisory services, supervisors may get assistance from external auditors or actuaries to whom they delegate, in part or completely, on-site inspections. Using these professionals may provide the supervisory authorities with flexibility and augment their skill.
28. However, since supervisors remain responsible for the supervision, before using external auditors or actuaries, they should consider:

- a. whether adequate controls over their competence exist and the need to monitor their performance (for instance, through reviewing their working papers);
 - b. their independence towards the company (in particular when they are paid by the Board of Directors) and the consideration they give to the protection of the policy holders' interests.
29. Besides, should such a delegation be set up, the supervisor should have the ability to take legal action against these auditors and actuaries, if necessary.