



On and Offsite Inspections

Michael Hafeman and Tony Randle

PRIMER SERIES ON INSURANCE
ISSUE 13, DECEMBER 2009

NON-BANK FINANCIAL
INSTITUTIONS GROUP

GLOBAL CAPITAL MARKETS
DEVELOPMENT DEPARTMENT

FINANCIAL AND PRIVATE SECTOR
DEVELOPMENT VICE PRESIDENCY



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THIS ISSUE

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The Primer Series on Insurance provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

The Non-Bank Financial Institutions Group in the Global Capital Markets Development Department aims to promote the healthy development of insurance, housing finance, and pension markets, and to expand access to a broad spectrum of financial services among the poor. These markets provide opportunities for household investment and long-term savings, and can buffer the poor against the risks of sickness, loss of breadwinner, catastrophic events, and other misfortunes.

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On and Offsite Inspections

Michael Hafeman and Tony Randle

Onsite Inspection

A. What is onsite inspection?

An inspection is an official examination or review. The term “onsite” means that the inspection takes place wherever the subject of the inspection happens to be located. In the insurance sector, supervisory authorities perform onsite inspections of insurers and intermediaries. Inspections sometimes extend to other entities that can affect the operations of insurers and intermediaries, such as affiliated companies and providers of outsourced services.

Onsite inspection is an important part of the supervisory process. The Insurance Core Principles (ICPs) of the International Association of Insurance Supervisors (IAIS) include a principle on onsite inspection, ICP 13, which states:

The supervisory authority carries out onsite inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

ICP 13 is accompanied by various explanatory notes that help to put it in context, along with six essential criteria that should be met in order for an onsite inspection program to be effective. The criteria are set out below, together with brief explanations of why they are important.

i. By law, the supervisory authority has wide-ranging powers to conduct onsite inspections and gather information deemed necessary to perform its duties.

A supervisory authority must have the legal power to conduct onsite inspections. It is unsatisfactory to require the permission of the party that is to be inspected, because those with the most significant problems are the least likely to grant permission. The supervisory authority should be able to adjust the nature, scope, timing, and frequency of onsite inspections to different situations and supervisory needs. The supervisory authority must have sufficient powers to obtain the information that it needs while on site, so that it can investigate any areas of concern fully.

ii. The supervisory authority, external auditors, or other suitably qualified parties verify information in regulatory returns periodically through onsite inspections. Where parties other than the supervisory authority verify information, then arrangements for communication with the supervisory authority should be established.

Regulatory returns can be an important source of information for supervisors, particularly when assessing the financial strength of insurers. Supervisors should not take the regulatory returns as accurate simply because those submitting the returns say they are, nor should they rely entirely on offsite analysis to identify problems with this information. However, a sampling process may be employed, rather than verifying every detail of every return.

This verification is similar to the work performed by external auditors before providing an opinion on a company's annual financial statements. Therefore, in some jurisdictions, supervisory authorities entrust external auditors or other suitably qualified parties with the task of onsite verification, as an alternative or supplement to doing the work themselves. In such cases, open communication with the outside parties facilitates the discussion and resolution of concerns arising from the reviews.

iii. The supervisory authority may conduct onsite inspections on either a full-scale or a focused basis, investigating areas of specific concern.

A full-scale onsite inspection is a wide-ranging look at the finances and operations of an insurer. It can greatly assist the supervisory authority in arriving at a comprehensive assessment of the insurer's risk profile, viability, and compliance with requirements. Full-scale inspections can consume a lot of supervisory resources. A focused inspection looks at selected aspects of an insurer's finances or operations. They can often be performed more quickly and with fewer resources than a full-scale inspection, which is particularly important if a specific supervisory concern has arisen and needs to be investigated. The flexibility to use both full-scale and focused inspections, as the situation may require, enables a supervisory authority to use available resources effectively and efficiently.

iv. The supervisory authority promptly discusses findings and any need for corrective action with the insurer and obtains appropriate feedback from the insurer.

Prompt communication is in the best interest of the supervisory authority, the insurer, and consumers. If problems exist, the sooner the insurer discovers them, the sooner they can be corrected and the risks to consumers reduced. Communication should not be limited to a formal written report from the supervisory authority to the insurer. Discussion provides an opportunity to correct any factual errors in the findings and explore alternative approaches to dealing with any supervisory concerns.

v. The supervisory authority follows up with the insurer to ensure that any required action has been taken.

If an onsite inspection points to the need for an insurer to take action, it is essential that the action actually be taken. Without action the situation will not improve and could deteriorate—in some cases, rapidly and significantly. The supervisory authority must follow up to ensure that progress is being made.

vi. The supervisory authority can extend onsite inspections to obtain information from intermediaries and companies that have accepted functions outsourced by the supervised insurer.

Intermediaries and companies to whom an insurer has outsourced functions can play significant roles in the operation of an insurer. The supervisory authority may need information from such parties to form a complete picture of the risks to which an insurer is subject and the adequacy of its controls to deal with these risks.

This section provided a brief overview of what an onsite inspection is and the conditions that contribute to a successful inspection program. These issues will be revisited in the other sections, which explore the following questions:

- Why perform onsite inspections?
- When are onsite inspections performed?
- Who performs onsite inspections?
- How are onsite inspections performed?

B. Why perform onsite inspections?

Insurance supervision exists for the benefit and protection of policyholders. Supervisory activity directed at protecting policyholders from the risk that insurers will be unable to meet their obligations is called prudential supervision. Supervisory activity directed at ensuring fair treatment of consumers is called market conduct supervision. In some

jurisdictions, prudential and market conduct supervision is performed by different supervisory authorities.

How can these supervisory objectives be achieved? Regulatory requirements, if properly formulated, should support the prudent operation of insurers and the successful functioning of the insurance market, thereby protecting consumers. Supervisory authorities have traditionally focused largely on assessing whether insurers and intermediaries are complying with regulatory requirements. The rationale for this compliance assessment approach is that if the rules are formulated properly and followed strictly, the result will be satisfactory.

However, the complexities of the insurance business and commercial realities make it impossible to design regulatory requirements that will ensure the achievement of supervisory objectives. Accordingly, many supervisory authorities have begun to adopt risk-focused supervisory approaches that explicitly consider how insurers manage their business and the risks that it entails. Supervisory analysis of risks may focus on the various significant activities of an insurer, which could, for example, be a line of business, a geographic area of operation, or a department within the company. Taken together with an analysis of an insurer's current and prospective financial situation, the supervisory authority can develop an overall assessment of the risk that the insurer will be unable to meet its obligations to policyholders.

Supervisory authorities often incorporate aspects of each of the above approaches in their work. The relative emphasis placed on each may vary to reflect differences in factors such as supervisory philosophy, the stage of development of the market, the extent to which the supervisory authority can rely on the work of others, and the capabilities of supervisory staff.

Supervisory authorities collect many types of financial and other information about those they supervise. The offsite analysis of this information is an essential step toward understanding the situation. However, it is unlikely that such second-hand analysis of information provided by others will provide a fully adequate picture of the situation. Onsite inspections give the supervisory authority *a first-hand look* at what is going on. This contributes greatly to the effectiveness of the supervisory authority, regardless of the supervisory approach. Likewise, it is relevant to the assessment of financial, governance, and market conduct matters.

As explained in the ICPs, a full-scale inspection for prudential purposes should include, at a minimum, the following activities:

- *Evaluation of the management and internal control system*
- *Analysis of the nature of the insurer's activities, such as the type of business written*

- *Evaluation of the technical conduct of insurance business or evaluation of the organization and management of the insurer, the commercial policy, and the reinsurance cover and its security*
- *Analysis of the relationships with external entities, such as through outsourcing or with respect to other companies in the same group*
- *Assessment of the insurer's financial strength, notably the technical provisions*
- *Evaluation of compliance with corporate governance requirements.*

A full-scale inspection of market conduct should include, at a minimum, the following activities:

- *Checking the sufficiency and adequacy of the information given to consumers*
- *Reviewing the timing of payments*
- *Reviewing the frequency and nature of litigation*
- *Assessing the observance of market conduct standards and consumer regulations.*

The first-hand look provided by an onsite inspection is essential in making such assessments. Consider the following examples:

When assessing compliance with financial requirements, an onsite inspection provides the opportunity to check the reliability of the data and to discuss and assess the assumptions, methods, and systems used by the insurer in its calculations.

When assessing the quality of governance, an onsite inspection enables the supervisor to assess the effectiveness of the insurer's decision-making processes, the manner in which its internal controls are being applied, and a sense of how well run an insurer is.

Focused inspections might be performed in order to take a close look at a particular aspect of an insurer's operations, such as how a change in ownership has affected the corporate governance processes of the insurer.

While on site, sometimes a supervisor will identify significant issues that had escaped the attention of management or that management had identified but chosen to ignore or to hide. Once they know and have confidence in the supervisor, staff of an insurer may well bring such issues to the supervisor's attention.

Onsite inspections can also *support the intervention activities* of a supervisory authority. An onsite inspection provides the supervisor with the ability to raise issues of concern with management on an informal basis, perhaps before they develop into major problems. It also enables the supervisory authority to better assess the situation of the insurer

and reach supervisory conclusions. More formally, the documentation of concerns arising from an onsite inspection provides the basis for further corrective measures, enforcement actions, and sanctions that may be necessary if the concerns are not resolved satisfactorily. In some jurisdictions, legislation explicitly requires that an onsite inspection be performed before certain supervisory actions may be taken.

Focused inspections can also be used to help the supervisory authority to *identify and understand issues that may affect many insurers*. For example, focused inspections might be conducted of the derivatives operations of each insurer that is active in this area. The inspections can provide a better understanding of the derivative products being used by the insurers, how each insurer is using them, and the risk management practices that are being used. The analysis of inspection findings may highlight industry-wide risks, be useful in establishing best-practice benchmarks in risk management, and identify insurers whose risk management practices are inadequate.

Onsite inspection *builds supervisory capabilities*, with benefits that extend well beyond the period in which the supervisors are on site. The understanding of an insurer's operations, the relationships with members of its board, management, and staff, and the first-hand knowledge of the challenges faced by insurers and intermediaries in complying with regulations can be valuable to a supervisor. They can help the supervisory authority to identify significant issues more readily during its offsite analysis, to obtain relevant information more quickly, to understand the operations and risks faced by the industry more thoroughly, and to formulate more appropriate policies.

In some jurisdictions, the importance of onsite inspections has been reflected in legislation, and supervisory authorities perform onsite inspections *to meet legal requirements*. Legislation sometimes requires that regular inspections be performed. Sometimes, as mentioned above, it requires an onsite inspection before certain supervisory actions are taken.

In summary, supervisors have much to gain by venturing out of their offices and conducting onsite inspections. Onsite inspections are an essential supervisory tool in their own right and can contribute to the effectiveness of other supervisory activities.

C. When are onsite inspections performed?

Many factors can influence the decision of a supervisory authority about when an onsite inspection should be performed. In most cases, these factors are closely related to the reason for performing the inspec-

tion. For example, inspections may be performed as part of the routine supervisory assessment process, in relation to requests for regulatory approvals, or in response to serious supervisory concerns. The urgency, frequency, and timing of onsite inspections can differ significantly among these different situations.

Onsite inspections that are part of the ongoing supervisory assessment process are usually done regularly. In some jurisdictions, legislation specifies the minimum frequency with which an inspection must occur, while in many others, supervisory authorities have established a tradition of inspecting each insurer regularly. For example, a full-scale inspection each insurer may be done annually or biannually. Sometimes the frequency may vary, based on factors such as the size, nature, and risk rating of an insurer, to use scarce supervisory resources as effectively as possible. A supervisory authority can often plan for regular inspections well in advance, which provides some flexibility in scheduling them to accommodate factors such as financial reporting cycles, resource constraints, and holiday periods.

The timing of an inspection in support of the regulatory approval process can sometimes be predicted, for example, in the case of those related to licensing renewals. More often, however, such inspections are triggered by a particular event, such as a new license application, the proposed acquisition of a subsidiary by an insurer, or a possible change in control of an insurer.

Focused inspections are frequently performed in response to specific supervisory concerns about a particular insurer. Concerns that arise from a full-scale inspection or from offsite monitoring and analysis might trigger a focused inspection, for example, of investment management. The need for a market conduct inspection may be identified as a result of formal complaints by consumers or informal market intelligence. Sometimes the situation poses such significant risk that an inspection will be required urgently.

Although it is impossible to predict with certainty when each inspection will be needed, planning is nevertheless important. Supervisory authorities commonly take a comprehensive look at the onsite inspection program at least annually. As part of the planning process, they should consider the situation with respect to each insurer, developments in the market as a whole and past experience with the inspection program. This will help them to identify inspection needs, determine the most appropriate types of inspections to meet these needs, estimate the resources needed to carry out these inspections, identify the resources available to carry out the inspections, and establish inspection priorities. Taking all of these factors into account, a plan for the inspection program can be mapped out. Since the inspection

program is almost certain to be affected by unexpected events, findings, and calls on resources, the plan should incorporate some flexibility.

D. Who performs onsite inspections?

As discussed in section B, onsite inspections can play many roles in the supervisory process. Accordingly, it is not unusual for a majority of the staff of a supervisory authority to be involved in onsite inspection activities. Depending on the structure of the organization, those involved might work solely on onsite inspections, or might also perform offsite monitoring and analysis. Even in supervisory authorities where there is a specific onsite inspection department, staff from other departments are often involved. For example, some supervisory authorities have individuals or departments that specialize in matters such as actuarial, accounting, compliance, technology risk, and investments. In such cases, some or all of the time of these specialists may be available for onsite inspections.

Ordinarily, one person is designated as the team leader for a particular inspection, responsible for ensuring that the inspection is planned and executed properly. For example, the supervisor who has overall responsibility for the supervisory authority's relationship with a particular insurer may take the lead in full-scale inspections of that insurer. The designation of a team leader facilitates communication both within the supervisory authority and between the authority and the insurer.

An inspection team must include individuals with the necessary expertise to carry out the inspection. Team members should understand the aspects of the insurer's operation to be inspected, be knowledgeable about inspection techniques and procedures, and be capable of critically evaluating the information that will be obtained during the inspection. If a highly technical aspect of the insurer's operation is to be inspected, special knowledge or experience may be required, and there might be no one on staff with the necessary expertise. The team leader will need to overcome such obstacles—for example, by allocating inspection responsibilities to make the best possible use of the persons available, by borrowing persons with the necessary skills from other teams or departments within the supervisory authority, or by seeking external expertise. In the end, the inspection plan may need to be revised in order to reflect the resources that are actually available.

Supervisory authorities may also outsource some of their work or use external specialists, and such resources might be involved in onsite inspections. If so, the supervisory authority needs to ensure that such

resources are competent, are independent of the insurers, and maintain confidentiality. Examples of the ways in which some supervisory authorities use external resources include retaining auditors to inspect internal controls and verify the information contained in financial regulatory returns; contracting retired investment executives to inspect investment policies, procedures, controls, and adherence to them; and retaining actuaries to evaluate the sufficiency of technical provisions.

Sometimes the work of various parties outside the supervisory authority can be relevant to the onsite inspection program, even if such work was not performed as part of an onsite inspection or to meet the specific needs of the supervisory authority. For example:

- In order to provide a written opinion, the external auditor evaluates the data, processes, and controls that are relevant to the reliability of the insurer's financial statements;
- Insurers often have an internal audit function, charged with evaluating and monitoring the adequacy and effectiveness of internal controls and risk management processes; and
- In many jurisdictions, the liabilities of an insurer must be valued by an actuary, who may be required to prepare a report for the board of directors and the supervisory authority that describes the data, methods, and assumptions used in the calculations, and to provide an opinion regarding the sufficiency of the provisions.

At a minimum, the supervisory authority should review the reports of these third parties and investigate any significant areas of concern that arise from such monitoring. Analysis of the reports and communication with those who prepared them can help the supervisory authority to assess their capabilities and the scope and quality of their work. If the supervisory authority has confidence in their work, the ability to rely on it can affect the nature of the onsite inspection program. For example, if the external auditor has conducted a detailed review of an insurer's investment controls and asset valuation methods, the supervisory authority may need to do little work in this area during the onsite inspection.

E. How are onsite inspections performed?

The preceding sections have discussed different types of onsite inspections, the factors that influence why and when they would be performed, and who might perform them. This section discusses how onsite inspections are performed. It describes each of the main steps

involved in performing a particular onsite inspection: planning and preparation; fieldwork and documentation; assessment and reporting; and follow-up.

PLANNING AND PREPARATION

Careful planning and preparation can contribute significantly to the effectiveness and efficiency of an onsite inspection. They enable the inspectors to focus on the areas of highest priority, ask relevant questions, complete their work in a timely manner, and minimize any disruptions to the insurer's operations. There are several steps in the planning process, as follows:

- Establish priorities for the various areas to be inspected. Even in a full-scale inspection, it is usually appropriate to give certain areas more attention than others;
- Define the nature and scope of the inspection that will be performed in each of the areas to be inspected, detailing the inspection activities that will be carried out, the time that will be spent on each activity, and the time line. While many factors will affect the amount of time spent in the field, it is not unusual for a full-scale inspection of a small insurer to involve two weeks of fieldwork by a team of three or four supervisors;
- Secure individuals with the necessary expertise for the inspection team, as discussed in the previous section;
- Identify the additional information that will be needed to prepare for the inspection. The supervisory authority will often have a considerable amount of information about the insurer that can be used in preparing for an inspection. Nevertheless, an onsite inspection is intended to elicit information that is not already in the supervisory authority's files, and some of this information might usefully be requested of the insurer before the team goes into the field;
- Communicate with the insurer about the inspection plans. In most cases, it is best for both the supervisory authority and the insurer to initiate such communication well in advance of the fieldwork. This enables the insurer to take the inspection into account in planning its own activities, gives it time to prepare any additional information requested, and helps to ensure that relevant members of its staff are available to meet with the supervisors when they are on site. However, when an inspection is being conducted in response to a serious concern that has recently

arisen, little advance notice will be possible. If serious breaches of legislation are suspected, a surprise inspection may be essential in order to prevent the insurer from destroying or altering incriminating documents;

- Review and analyze the information available, both existing information and information that has been provided by the insurer in response to the pre-inspection request. This can highlight areas for further investigation or discussion while on site, and identify the sample of transactions or files that will be reviewed; and
- Select and adapt the tools that will be used to help gather information while on site, such as checklists, assessment criteria, and questionnaires.

FIELDWORK AND DOCUMENTATION

Fieldwork is the core of the onsite inspection process. During its time in the field, an inspection team should efficiently gather the information needed to meet the objectives of the inspection. The information that is gathered should be documented carefully in order to facilitate further analysis and support any conclusions and recommendations that arise from the inspection.

Good communication with the insurer's management and staff can contribute significantly to the effectiveness of the fieldwork. It is common to hold an opening meeting at the beginning of the fieldwork. In such a meeting, the team leader and members can meet the key individuals with whom they will be dealing during the inspection and clarify the specific responsibilities of each. The scope and objectives of the inspection can be reviewed and reinforced, and the various activities that will be carried out can be described. A schedule of working sessions involving specific team members and staff of the insurer, in connection with the various inspection activities, can be prepared or confirmed.

The team leader is responsible for managing the fieldwork. This involves monitoring the work of the inspection team in order to ensure that the planned inspection activities are completed properly and on schedule. If not, the team leader needs to act promptly—for example, reallocating responsibilities among team members, providing coaching, obtaining additional resources, or adjusting the inspection plan. Regular team meetings can provide an excellent means of tracking progress, discussing operational concerns, and sharing preliminary findings.

The inspection plan may include a range of activities to be used in gathering information about the insurer's financial condition and operations, such as the following:

- Interviews with relevant members of the insurer's management and staff;
- Review of written or electronic documents, such as minutes, reports to management, quantitative reports, corporate policies, and procedure manuals; and
- Analysis of detailed records, such as policy master files, claim files, investment files, and actuarial valuation files.

It is essential that the supervisors have access to all information relevant to their inspection. If staff or management of an insurer impedes supervisors' access to information, the team leader should immediately seek to resolve the situation. In most jurisdictions, legislation provides that the failure to provide information required by a supervisor is a punishable offence.

Substantive procedures are one common type of inspection activity. They would include tests of the details of various classes of transactions, account balances, and disclosures. They might also include analytical procedures—for example, using computer software tools to analyze claim payment data in order to identify improper or inaccurately recorded payments. External auditors typically perform substantive procedures to detect material misstatements of financial information. However, supervisory authorities might apply them to a broader range of investigation—for example, to identify noncompliance with legal requirements or an insurer's internal policies.

Tests of control are another common type of inspection activity. Tests of control are performed to obtain evidence about the operating effectiveness of controls. External auditors would focus on testing the effectiveness of controls in preventing, or detecting and correcting, material misstatements of financial information. Once again, supervisory authorities might apply such tests more broadly. For example, the policies and procedures governing the investment process might be reviewed with the objective of identifying weaknesses. Investment transactions might then be analyzed to evaluate whether the procedures and controls, even if they appear sound on paper, are applied successfully in practice to ensure that investment activities are carried out in accordance with the insurer's investment policy. It is essential that the quality of internal auditing be assessed when evaluating an insurer's control environment. The quality of the internal audit func-

tion depends on such factors as its mandate, independence from operational management, staffing levels and capabilities, and work program.

Substantive procedures are designed to detect actual problems with the underlying information or transactions, while tests of control are designed to evaluate the extent to which an insurer's controls can be relied on to keep such problems from existing. If an insurer's controls are generally weak, management has in the past failed to enforce the observance of controls, or the scope or quality of internal and external auditing is inadequate, substantive procedures are required. However, if an insurer's controls are generally adequate, controls are typically observed by the insurer's staff, and internal and external auditing is adequate, supervisory resources might best be devoted to tests of control. In practice, the situation may not be clear-cut, in which case both techniques might be used to some extent.

An onsite inspection can generate a large amount of information of various types. This information should be documented carefully and organized in a manner that will make it easily accessible and useful. Appropriate documentation of inspection findings facilitates further analysis and supports any conclusions and recommendations that arise from the inspection. Conversely, poor documentation can make it very difficult to identify significant issues or support preventive or corrective measures.

It is useful to complete the basic documentation while the fieldwork is under way. This supports preliminary analysis of the findings and helps to identify any areas in which additional information may be required. To assist in documentation of the findings, some supervisory authorities have prepared electronic versions of their information-gathering tools, into which supervisors using portable computers can enter the information as it is gathered.

As the fieldwork progresses, the documentation should build from raw data to working papers and then to section notes. The findings should be reviewed and discussed by the team, providing the basis for preliminary conclusions on the results of the inspection.

When the inspection team has completed its fieldwork, it should have a closing meeting with relevant members of the insurer's management. In such a meeting, the inspection activities performed can be reviewed briefly, the most significant findings can be presented, and feedback obtained on whether management was aware of any problems identified in the inspection and is prepared to deal with them. The closing meeting also enables management to identify factual errors or misunderstandings on the part of the supervisors and to correct them.

At the closing meeting, the team leader should explain the subsequent steps in the supervisory process and their expected timing. These steps typically include further supervisory analysis, the issuance of a formal report to the insurer, the insurer's written response to the report, and so forth. Finally, if the insurer's staff were cooperative with the inspectors, it would be appropriate to acknowledge this in the closing meeting.

ASSESSMENT AND REPORTING

Simply completing the fieldwork does not mean that the work of the onsite inspection is finished. The supervisory authority must fully assess the findings, update its overall risk assessment of the insurer, determine the consequential actions that should be taken, and deal with the insurer to implement these actions.

Supervisors assess the findings in order to identify the issues of greatest concern and consider the effects of these issues on the supervisory risk assessment. Based on its assessment, the supervisory authority must decide what steps should be taken, by both itself and the insurer. For example, the supervisory authority may place the insurer under closer supervision, perform an additional onsite inspection, or impose sanctions. It needs to decide what types of actions it will request—or require—of the insurer. For example, it may direct the insurer to strengthen its controls in particular areas, revalue its technical provisions using more prudent assumptions, or cease underwriting a particular class of business. The supervisory authority should have processes in place to ensure that its assessments, and the resulting actions, are fair and consistent.

A summary report on the inspection and recommendations normally is prepared for management. If the insurer is large or the findings are serious, the report may require the concurrence of the head of the supervisory authority.

The supervisory authority should communicate with the insurer regarding the results of its assessment. In some jurisdictions, legislation requires such communication. Communication often includes a formal written report or letter sent to the insurer's chief executive officer and, if required by law or if concerns are particularly serious, to the insurer's board of directors. Some supervisory authorities normally meet in person with relevant members of the insurer's senior management, such as those responsible for the operations that were inspected, to present the report.

The report or letter should state concisely what was found, what the problems are with the findings, and what should be changed to remedy the situation. Time lines should be provided, both for responding to the letter and for taking action in response to the recommendations. The insurer should be required to respond in writing; in some jurisdictions, a response is required by law. The response should confirm agreement with the findings and recommendations or indicate specific areas of disagreement, and it should include action plans, with time lines, for dealing with the recommendations. If the insurer's response is not satisfactory, the supervisory authority will need to consider taking formal corrective action or imposing sanctions.

FOLLOW-UP

An insurer may have submitted satisfactory plans to deal with the concerns raised by the supervisory authority. Unfortunately, this does not guarantee that it will follow through and implement these plans effectively. It is therefore important for the supervisory authority to develop and implement its own plan for following up with the insurer to ensure that the necessary actions have been taken.

The nature and frequency of the supervisory follow-up will vary according to the situation. If the concerns are not serious and the insurer is generally diligent about meeting its commitments to the supervisory authority, it may be sufficient to follow up during the next regular onsite inspection. Conversely, if the supervisory concerns are serious and the insurer has a history of noncompliance, frequent follow-up may be necessary.

Follow-up activities can include periodic conversations with the insurer's management on the telephone or in person, review of the insurer's project status reports, and analysis of special financial reports that the insurer may be required to submit to the supervisory authority. In some cases, a focused onsite inspection may be needed to assess whether an insurer has effectively dealt with supervisory concerns.

Finally, it is important to remember that the successful completion of an onsite inspection is not the end of the story. It is part of the ongoing process of supervision. If the inspection was successful, the same concerns should not resurface in the next inspection. However, management, products, marketing programs, market conditions, and the economy all change over time, posing new challenges with which insurers and intermediaries must cope. Onsite inspection is an essential

tool that enables the supervisory authority to contribute to the insurance industry's success in coping with these challenges, thereby safeguarding the interests of consumers.

Offsite Inspection

A. What is offsite inspection?

Most insurance legislation contains requirements for disclosure to both the supervisory authority and shareholders. The contents, format and frequency of these disclosures ideally should be specified in the main or subordinate legislation. Offsite inspection refers to the process of reviewing the information that is provided by the insurer.

Offsite inspection is an important part of the supervisory process. It provides supervisors with information about both current and impending issues within an insurer that may not have been otherwise detected until the next onsite inspection.

The collection and maintenance of reliable and accurate data is a significant function of the supervisory authority. Reliable data enables the supervisor to discern trends in the industry and within individual insurers. Testing the accuracy of data submitted by insurers needs to be part of onsite reviews as noted in the sections concerning onsite inspections. The failure of an insurer to provide accurate information to the supervisory authority may point to problems within the insurer in that it cannot provide the information (operational risk) or it does not treat its legal obligations appropriately (governance and legal risk).

B. Why perform offsite inspections?

Offsite inspection is part of the supervisory framework that authorities have put in place to ensure that, under all reasonable circumstances, insurers are able to honour their obligations to policyholders.

Supervisory authorities generally conduct onsite reviews on a routine cycle, often determined by the relevant authority's assessment of the risk profile of individual insurers. The offsite review process enables authorities to supervise insurers between onsite reviews. Onsite reviews are frequently targeted at one part of an insurer's activities (a particular business line or a geographical segment for example). Offsite reviews permit the authorities to study the insurer's entire business holistically. An important part of the offsite process that is linked to the

collection of accurate data is the ability of the supervisory authority to analyze the performance of particular insurers against their peers and the industry.

C. When are offsite inspections performed?

Most legislation specifies the content and format of regulatory returns and the frequency with which the returns must be provided to the supervisory authority. Ideally, the analysis of the data provided should be conducted within a definite time period after the lodgement of the returns.

Additionally, supervisory authorities should require insurers to lodge copies of their annual reports to shareholders. An offsite analysis of these reports should also be conducted within a definite time period. The annual report will include detailed financial information that has been subject to audit. Supervisors should analyze these reports against information previously provided to validate that information and to ascertain whether there have been any events that have occurred after the last balance date that have materially impacted the financial position of the insurer.

D. Who performs offsite inspections?

Ordinarily, one person or a team has responsibility for the relationship between the supervisory authority and the insurer. In this case, the person or a designated member of the team will conduct the offsite inspection.

It is important to retain some continuity in relation to the personnel involved in the offsite inspection of individual insurers to ensure that the knowledge and understanding of the insurers is preserved.

E. How are onsite inspections performed?

Preferably, the supervisory authority should have developed and should maintain a database in which the information provided by insurers is entered. The database should have the capability of generating common ratios for each insurer, cohorts of insurers (where relevant) and the industry in aggregate. It should also have the capacity to generate trends over time in important variables such as gross written

premium, earned premium, claims paid, expenses and so forth for each insurer, cohort and the industry as a whole. Where such a database is not available, the supervisor needs to calculate the ratios.

The supervisor should review the information provided and note any deterioration in the overall performance of the insurer and each individual line of business where there is sufficient data to do so. The supervisor should review each of the ratios calculated against ratios calculated for the insurer for previous periods and against industry and cohort ratios. Where there are significant differences compared with previous reporting periods or with industry or cohort ratios, the supervisor should determine the reasons for the differences and document them. An explanation may be at hand if the supervisory authority has already questioned an item relating to previous returns, in which case the supervisor needs to access previous offsite reviews. However, it may be necessary to contact the insurer to obtain explanations. Having reviewed the data provided by the insurer and compared it with previous reports and cohort and industry data, the supervisor needs to form a view about any change to the risk assessment of the insurer since the previous onsite or offsite review, whichever is the later.

It is essential to maintain proper documentation of each offsite review. Many supervisory authorities have prepared templates and other tools for doing this. In fact, some authorities are able to populate the templates with the ratios and trends from their database prior to the supervisor commencing the onsite review. The documentation should detail the analysis of each relevant piece of data and provide explanations where warranted. The documentation should also comment on the accuracy and timeliness of the data, which can be an indicator of the quality of the controls and management in the insurer. Supervisors should discuss the outcome of each offsite review with team members and their managers.

Each year, the supervisory agency needs to obtain a copy of each insurer's annual report and audited financial statements. The supervisor needs to compare the data within the annual report against the relevant regulatory returns to ensure that the data provided in the regulatory returns is consistent with the audited financial statements. Where there are material differences, the supervisor needs to follow up with the insurer, ascertain the reasons and have the regulatory returns amended if necessary to ensure the integrity of the data maintained by the authority. The report of the statutory auditor can point to matters of concern to the supervisory agency; therefore supervisors need to review the audit report and where there are qualifications in the report, discuss these with the insurer and, if appropriate, its auditors.

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