

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS



GUIDANCE PAPER ON COMBATING THE MISUSE OF INSURERS FOR ILLICIT PURPOSES

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1. Introduction

1. Experience has shown that there is a risk of insurers being used as vehicles for illegal purposes, when they are acquired or controlled and/or managed by those with criminal intent, for example to disguise the origin of illegal funds or to commit fraud.

2. The risk of an insurer being used for illicit purposes relates to various aspects such as:

- the objectives, business values and organisational culture of the insurer;
- the integrity of the board, management and staff;
- the decision making processes within the insurer, including its structure, transparency, and adequacy of checks and balances;
- the effectiveness of the internal controls and the way the operational processes are structured, including the existence of adequate control mechanisms such as division of duties;
- adequate management and information systems;
- the environment and markets in which the insurer has to operate, sometimes under pressure;
- the effectiveness of the supervisory regime.

3. Therefore, the complexity and dynamics of an insurer call for an approach that is not limited to a single aspect of its organisation, such as the integrity of the board and management.

4. This guidance is being issued to assist supervisors in combating the misuse of insurers for illicit purposes by:

- providing indicators of higher risk situations to help broaden the perspective of supervisors in their daily activities;
- assessing the risk by focusing on three main areas of attention; corporate governance, the group structure, and business relationships and transactions with related and third parties;
- encouraging supervisors to address the risk in this area.

5. This paper does not intend to impose new requirements or supervisory activities on supervisors where their current practices include reviewing matters raised in this paper for other prudential purposes.

6. Supervisors should be aware that, in respect of the functions and responsibilities of directors, there are differences in legislative and regulatory frameworks from jurisdiction to jurisdiction. In some jurisdictions, there is a two tier board system consisting of a supervisory board, which has a main function of supervising the management board. Thus, the supervisory board has no executive functions. In other jurisdictions, with a unitary board system, the board has a broader responsibility. In this regard, fitness, propriety or other qualification tests should be applied to directors in the light of their role and responsibilities, taking into account the structure of the boards.

7. This guidance paper should be read in conjunction with the following Insurance core principles:

- Principle 5: Supervisory cooperation and information sharing
- Principle 6: Licensing
- Principle 8: Changes in control and portfolio transfers
- Principle 9: Corporate governance
- Principle 10: Internal control
- Principle 13: On-site inspections

2. Risks involved

8. The involvement of insurers in illegal activities poses a risk to the integrity and stability of the insurance industry and the financial system as a whole.

9. At corporate level this involvement forms a risk to the reputation of the insurer concerned and creates a risk of inadequate or inappropriate direction, control or influence. Also the illegal activities could lead to supervisory action and/or criminal prosecution.

3. Activities of supervisors to address misuse of insurers

A. General

10. Supervisors should be vigilant to ensure that insurers are not established, controlled, infiltrated in any way or used by any other means for illicit purposes. Examples of such illicit purposes are:

- (a) involvement in schemes or structures set up to channel proceeds of crime to other companies or individuals to disguise the illegal origin of the funds from activities such as corruption or financial crime (including fraud and money laundering);
- (b) use of the legal operations of the insurer to cover up other illegal activities.

11. This vigilance is required both at the licensing stage and during ongoing supervision.

12. Supervisors should incorporate this vigilance into the ongoing supervision by focusing on anomalies and unusual situations. Supervisors should take a critical stance towards any information provided to them and seek independent verification when necessary.

13. In a case where the supervisor has concerns about whether the insurer is or is likely to be misused, the supervisor should investigate further. If necessary, the supervisor should take preventative and corrective action at an appropriate level, including fining, dismissal of directors, suspension of business, withdrawal of the business license, and/or reporting to the appropriate law enforcement agencies or financial intelligence units.

B. Ongoing supervisory focus and vigilance

14. The vigilance as described applies specifically but not exclusively to:

- (a) the corporate governance of the insurer;
- (b) the group structure;
- (c) related and third parties (business relationships, transactions and commitments, like guarantees and joint ventures).

15. In the performance of its supervisory activities, the supervisor should be alert to indicators of a higher risk of fraud or other illegal activities. The existence of these indicators does not mean that fraud or illegal activities have occurred or will occur. Awareness of the following indicators will help focus attention on possible problem areas:

- Corporate governance and organisational setup:
 - (a) The board or management is dominated by one person or a few people and there is no effective internal body with supervisory responsibility;
 - (b) there is a complex structure without an apparent realistic purpose;
 - (c) there is no sound explanation why weaknesses in the internal control system are not being addressed;
 - (d) no four eyes principle operates within the decision making processes;
 - (e) there are a lot of changes of staff in key positions with financial or administrative responsibilities.

- Unusual pressure or strain within the insurer:
 - (f) the economic conditions in the sector are bad and there is a growing number of bankruptcies;
 - (g) there has been a sizeable investment made in the insurer;
 - (h) there has been a sizeable investment made by the insurer in a product which is sensitive to sudden external changes and fluctuations;
 - (i) the insurer is dependent on one or just a few products or suppliers;
 - (j) there is strong financial pressure on the board and management;
 - (k) there is undue pressure from board members on operations such as underwriting and claims settlement;
 - (l) there is pressure to deliver financial statements in an unusually short timeframe.
- Complex and unusual transactions:
 - (m) the origin of the source of the capital of the insurer is unclear;
 - (n) transactions are of a complex nature;
 - (o) there are transactions with related and third parties;
 - (p) there are transactions that appear unusual, for example:
 - (i) transactions involving unusual conditions such as unusual tariffs, interest rates, guarantees or repayment clauses;
 - (ii) transactions for which there is no logical economic purpose;
 - (iii) transactions that deviate from their legally prescribed form;
 - (iv) transactions that are processed in an unusual way in the books of the insurer;
 - (v) transactions with suppliers or other parties that, in size or payment, are substantially larger than other transactions;
 - (vi) unregistered or undisclosed management services;
 - (q) purchases or sales of capital interests for example in a joint venture or another company.
- Difficulties in obtaining sufficient supervisory information and documentation:
 - (r) insufficient explanation and documentary evidence with respect to transactions for example, lack of proper authorization;
 - (s) illogical or evasive replies to questions posed by supervisory staff or by the auditor;
 - (t) incorrect information.

C. Corporate governance structure

16. The board and management of the insurer need to be fit and proper in accordance with the *IAIS Standard on fit and proper requirements and assessment for insurers*.

17. The supervisor should determine whether there has been proper disclosure that a board member or manager has an interest, position or otherwise an involvement in related parties of the insurer.

18. Special attention is needed where a board member or another individual working in sensitive departments of insurers is considered to be politically exposed as described in the *IAIS Guidance paper on anti-money laundering and combating the financing of terrorism*.

19. The supervisor should identify who is actually controlling the decision-making of the insurer, who has major informal influence in this respect and if the board consists of "straw men". For this purpose the supervisor could check for example the register of shareholders and the minutes of meetings of shareholders, of the board and possibly of supervisory bodies within the insurer.

20. The supervisor needs to be aware of the strategy, objectives and policy of the insurer. These should be sufficiently realistic and take into account the interests of policyholders, beneficiaries and insurance claimants. The supervisor can then establish whether there is an enhanced risk as a consequence of pressure or strain to reach certain less realistic objectives. This could be the case in situations of tough competition or of new entrants into the insurance sector that need to gain a market share.

21. The supervisor should obtain a sense of the business values and organizational culture of the insurer. The corporate values of the insurer should emphasize the integrity of the organisation of the insurer on its board, management and staff. A code of conduct could serve as a codification of these values. In the code certain activities could be declared undesirable because of conflicts of interest.

22. The supervisor needs to be satisfied that an adequate compliance culture and structure exists within the insurer and also that there are effective internal controls in place. Depending on the size and legal form of the insurer, it may implement a separate supervisory body within the insurer, a compliance function and an internal audit function. These functions could be made responsible for issues such as compliance with applicable laws and regulations, and the prevention of fraud. (see Insurance core principle 10 for a more detailed description of internal controls).

D. Group structure

23. Insurers should only be part of a group if its structure is sufficiently transparent. The insurer or parent company of the group should provide an explanation for the way the group is set up. The group structure needs to have a sound business reason and purpose.

24. If the insurer is part of a group, the supervisor should identify which persons (natural or legal) take part in or have an influence on the decision making of the insurer (including major shareholders, significant owners, the parent company, other group associated companies and the board/management of those undertakings).

25. The supervisor should remain aware of changes in the formal and informal control structure of the group. It should especially be vigilant for a gradual increase of the interest in and/or control of the insurer ("creeping control").

26. For this purpose, the supervisor could check for example the register of shareholders, the minutes of the board and shareholders meetings of the insurer, as well as other relevant documentation such as the listing of acquisitions and participations by the insurer.

27. The supervisor could also check the register of shareholders and the minutes of board and shareholders meetings of the parent company, as well as other relevant documentation, such as the listing of acquisitions and participations or shareholdings of the parent company, if he has legal authority to do so.

E. Business relationships and transactions with related and third parties

28. The supervisor should identify - possibly on the basis of the work of the external auditor - whether there are related parties. Parties are considered to be related if one party has either the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions; or parties within a group structure without carrying out controlling powers or significant influence over the other party. A party that is not a related party is considered to be a third party.

29. Transactions with related parties can consist of a transfer of resources or obligations between related parties, regardless of whether a price is charged. Business relationships and transactions with related or third parties, in which a member of the board or manager has an interest, should be held and performed at arm's length. As appropriate, the non-executive directors or supervisory board, internal audit function, and compliance function should verify this is the case.

30. If a board member or manager holds a position in, or has an interest in a business partner of the insurer, his/her involvement in any transaction with that business partner should be controlled or if necessary be prohibited. For example, if a senior financial officer of the insurer is also an asset

manager with an affiliated bank, he should not have the sole responsibility or authority to carry out investment transactions for the insurer.

31. The internal control system of the insurer should be adequately set up and functioning with respect to transactions with related or third parties. Agreements, including side letters, of long duration or great importance to the insurer should be specifically monitored for conflicts of interest.

F. Cooperation between supervisors and other authorities

32. In order to perform its supervisory duties, a supervisor should, if necessary, share information and cooperate with insurance supervisors in other jurisdictions in a mutual and reciprocal way.

33. If other regulated financial institutions are part of the group or are related parties, this cooperation could also take place on a cross-sector basis with other supervisors.

34. If deemed necessary for collecting sufficient information or taking appropriate preventative and corrective action a supervisor should liaise with the appropriate law enforcement agencies and possibly the financial intelligence unit in its jurisdiction.

35. The aforementioned cooperation, whether national, cross-sectoral, international or with law enforcement agencies and financial intelligence units, is subject to requirements on data protection and confidentiality, as far as permitted by national and international regulation and treaties.

36. It should be noted that in accordance with the IAIS *Supervisory standard on the exchange of information*, the supervisor should have statutory power or legal authority, at its sole discretion and subject to appropriate safeguards, to share relevant:

- objective information on individuals holding positions of responsibility in insurers (to include major shareholders, significant owners, directors, managers, employees or contractors);
- objective information on individuals or insurers involved, or suspected of being involved, in criminal activities;
- information on supervisory investigations and reviews, and on any restrictions imposed on the business activities of insurers;

that it has obtained in the course of its own activities.¹

¹ *Supervisory standard on the exchange of information*, paragraphs 6 and 10; *Insurance core principle and methodology*, core principle No. 5, essential criterion (c) and core principle No. 7, essential criterion (e).

Appendix A: References

References

IAIS, *Glossary of terms*, 2005.

IAIS, *Guidance paper on anti-money laundering and combating the financing of terrorism*, 2004

IAIS, *Insurance core principles and methodology*, 2003

IAIS, *Supervisory Standard on fit and proper requirements and assessment for insurers*, 2005.

IAIS, *Supervisory standard on the exchange of information*, 2002