June 2006
IMF Country Report No. 06/217

Spain: Financial Sector Assessment Program—Technical Note—Supervision of Insurance: Alternative Models for an Independent Agency

This Technical Note on Supervision of Insurance: Alternative Models for an Independent Agency for Spain was prepared by a staff team of the International Monetary Fund as background documentation to the Financial Sector Assessment Program with the member country. It is based on the information available at the time it was completed in May 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Spain or the Executive Board of the IMF.

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International Monetary Fund
Washington, D.C.

FINANCIAL SECTOR ASSESSMENT PROGRAM

SPAIN

TECHNICAL NOTE ON SUPERVISION OF INSURANCE: ALTERNATIVE MODELS FOR AN INDEPENDENT AGENCY

MAY 2006

INTERNATIONAL MONETARY FUND
Monetary and Financial Systems Department

SUPERVISION OF INSURANCE: ALTERNATIVE MODELS FOR AN INDEPENDENT AGENCY

This note presents the Spanish authorities with a brief discussion of organizational alternatives for insurance supervision by discussing advantages and disadvantages of alternative institutional arrangements.[1]

1. **Regulation and supervision of insurance falls under the control of Ministerio de Economía y Hacienda (ME) through the Dirección General de Seguros y Fondos de Pensiones (DGSFP).** This arrangement is "unique" among Western European countries where insurance supervision is under independent agencies (Box 1). In Europe, there also seems to be a trend towards integrated financial sector regulators and supervisors (Gruenbichler and Darlap, 2004).[2]

2. **The assessment of observance of standards and codes raised two important issues in the organization of insurance**. First, the independence of the DGSFP from the government and, second, the ability of DGSFP to conduct group-wide supervision, supervision of conglomerates, and coordination with other supervisory agencies. Issues concerning the independence of the DGSFP can be grouped in three main categories (Quintyn and Taylor, 2002):

- **Operational independence**. The legal framework gives the Spanish government and the ME the power to issue both regulations and secondary rules based on proposals prepared by DGSFP. The DGSFP does not have legal capacity to issue rules by administrative means that are binding on the insurance industry.

- **Institutional independence**. There are no procedures in place regarding the appointment and dismissal of the head of the supervisory authority. While the DGSFP is not institutionally independent from ME, there is no evidence of undue political interference.

- **"Budgetary" independence**. The DGSFP does not have its own budget, in fact the budget allocated to the supervisory activities seems to be insufficient to attract and retain skilled staff and to develop the necessary supervisory infrastructure. Insufficient budgetary independence also creates obstacles to allocate resources in a timely manner in accordance with the risks the supervisory authority perceives.

[1] Prepared by Antonio García-Pascual (MFD).

[2] Such a trend can be observed in Asia as well (for example, Japan and Korea).

Box 1. Insurance Supervision in Spain and Other Western European Countries

1. Independent and integrated supervisory agency

UK:	FSA
Ireland:	FSA (under central bank)
Belgium:	Banking, finance and insurance commission
Germany:	BaFin
Austria:	Financial market authority
Denmark:	Danish financial supervisory authority
Norway:	Banking, securities and insurance regulator
Sweden:	Banking, securities and insurance regulator
Iceland:	Financial supervisory authority
Netherlands:	Central bank responsible for prudential oversight; Netherlands Authority for the Financial Markets responsible for conduct of business

While in all these countries a single agency covers the supervision of insurance, securities and banks, there are different organizational arrangements. For example, in the UK, the FSA is in charge of supervision of all three sectors and the Bank of England retains responsibility for macro financial stability. In Germany, while BaFin is responsible for supervision of the three sectors, the Bundesbank carries out banks' on-site supervision on behalf of BaFin. In the Netherlands, the central bank is the main supervisor for all sectors, however conduct of business is responsibility of the financial markets authority, a separate and independent agency.

2. Independent and separate supervisory agencies

France:	Commission de Contrôle des Assurances, Mutuelles et Institutions de Prévoyance
Finland:	Insurance supervisory authority
Switzerland:	Federal office of private insurance
Luxemburg:	Insurance supervisory authority
Italy:	Institute for supervision of insurance companies (ISVAP)
Portugal:	Instituto de Seguros de Portugal

The overall financial supervisory set up differs substantially in these countries as well. For example, in Italy, insurance, securities, and banking supervision are under three separate agencies. In Switzerland and Luxembourg, banking and securities supervision are responsibility of a single supervisory agency, whereas insurance is under a separate agency. In France, insurance supervision is under a separate agency, however, the insurance supervisor, which is responsible for prudential oversight, shares responsibility with other regulatory agencies: the Ministry of Economy, Finance, and Industry is responsible for regulation; and the Comité des Entreprises d'Assurance for licensing.

3. Insurance supervision under the umbrella of a ministry

Greece:	Ministry of Finance, Directorate of Insurance Enterprises and Actuaries—in the process of establishing a separate independent agency from the Ministry.
Spain:	ME, DGSFP

Source: IMF Staff.
1/ Consultations to integrate supervisory authorities are underway in Finland and Switzerland.

3. **A greater independence in all three dimensions can be best accomplished through the separation of insurance supervision from the ME.** The DGSFP is one of the several general directorates within the ministry and as such, there is no scope for independence. A separate independent agency from the ministry (a) would have greater

operational flexibility to develop, implement, and enforce regulatory policy; (b) would be better ring fenced against outside interference—conditional on an adequate structure and accountability of the agency's governing board; and (c) would have better and more flexible access to highly-skilled experts.

4. **Group-wide supervision, supervision of conglomerates, and coordination with other supervisory agencies constitutes another limitation of the current supervisory regime.** While the DGSFP has signed MoUs with bank and securities supervisors to create a framework for coordination and collaboration, in practice these agreements are limited to exchange of information on a case by case basis. As reflected in the detailed assessment of the observance of insurance standards and codes, there is no evidence of group-wide analysis or group-wide supervision of financial conglomerates from the insurance standpoint.

5. **While independence calls for separation of the DGSFP from the ME, it is a different matter whether supervisory agencies need to be integrated.** Irrespective of the institutional setup, risks associated with financial conglomerates demand "extra coordination" among supervisory agencies to ensure that the risks for the group are assessed and managed properly. The following section presents various organizational alternatives for independent insurance supervision.

A. Alternatives for an Independent Agency: International Experience

6. **Most recent insurance failures with potentially systemic impact involved life insurers or bancassurance companies, which played a role similar to banks in their investment activity (e.g. Japan and Korea) or sold deposit-like products (e.g. Jamaica and United States).** As pointed out by Das, Davies and Podpiera (2003), failure of an insurer may distress a related bank and cause contagion to the banking system and financial markets. Financial conglomerates, including bancassurance, pose new challenges to supervisors and regulators, such as complex intra-group exposures (e.g. credit risk transfer and use of credit derivatives), risk of contagion, risk of multiple gearing, and the potential for regulatory arbitrage within financial services groups (IMF, 2004).

7. **It is sometimes argued that risks associated with financial conglomerates require group-wide oversight to be conducted by an integrated supervisory agency**. Arguments in favor of an integrated agency include (Lumpkin, 2002):

- Efficiency in oversight and compliance: less duplication of supervisory effort through economies of scale and scope in the production, transmission, and interpretation of information. In the supervision of large complex financial conglomerates, the presence of a lead supervisor with *de facto* close collaboration among all supervisors becomes crucial, which tends to be facilitated by integrated supervisory agencies. Additionally an integrated approach builds supervisory capacity that facilitates analysis from a cross-sectoral perspective, which could be achieved through job rotation within the same agency.

- A level regulatory playing field: an integrated agency has greater potential for delivering a consistent approach—in rule making and oversight—across a range of institutional types.

8. **Arguments against an integrated agency include:**

- The loss of healthy competition between supervisors raises concerns about concentration of power in an independent body. In particular, (i) will a monopoly supervisor be inclined to over-regulate (arbitrary or excessively burdensome regulation)?; (ii) what if the integrated agency errs?; (iii) will an integrated supervisor be less innovative and competitive over time?

- Specialization in increasingly complex sectors may be partially lost or may be difficult to fit in. For example, insurance business requires specialized supervision with an emphasis in the adequacy of technical reserves in order to ensure customers protection. Such specialization may be more difficult to accomplish under an integrated supervisory regime.

9. **Overall, the legal configuration of integrated regulators differs substantially across countries, as well as the range of activities undertaken by the agencies**. Some agencies focus on prudential supervision of selected financial sectors, such as bank and insurance, or bank and securities, depending of which kind of financial conglomerates predominate. In some cases, the agencies are under the umbrella of the central bank, while others are fully independent agencies. In other cases, conduct of business (COB)—i.e. consumer protection, transparency issues, etc—are separate from prudential oversight, which may or may not be under the central's bank umbrella.

10. **Figure 1 shows various organizational models for an integrated financial supervisor**.[3]

- **In model 1, macro prudential supervision is under the umbrella of the central bank, while micro prudential supervision and COB are under an independent and integrated financial supervisor**. An example of this set up is the United Kingdom. In the separation of the FSA from the BoE, various factors were considered: (i) potential conflict of interest between macro and micro objectives; (ii) potential conflict of interest between monetary policy and prudential oversight; and (iii) reputational and moral hazard concerns raised by involvement of the central bank in the rescue of financial institutions.

[3] However, the concept of an *integrated* supervisory agency is interpreted differently in different jurisdictions. For example, in the UK, the FSA model has a common "Rulebook" for banking, securities and insurance. In Australia the institutional set-up is based on a "functional approach", which distinguishes between prudential oversight and conduct of business. In this regard, most countries tend to retain separate legislation and regulatory rules for banking, securities and insurance, and supervision may be undertaken by separate and distinct departments within a single agency.

- **In model 2, both macro and micro prudential supervision are under the umbrella of the central bank, while COB is under a separate independent agency**. Some of the key benefits considered by the Dutch government in merging micro and macro prudential supervision are that micro prudential surveillance requires a deep understanding of macro context, and macro prudential surveillance requires deep understanding of systemically important institutions and markets. [4]

- **In model 3, macro prudential supervision is under the central bank, micro prudential is under an independent and integrated agency, and COB is under a separate agency**. As an example, the Reserve Bank of Australia is in charge of ensuring the safety of the financial system as a whole, as well as the integrity and well-functioning of payment systems. APRA is in charge of the soundness of individual institutions, with a view toward protecting depositors from losses in the event of an institution's insolvency. COB is under a separate agency, which covers aspects of the ways in which financial institutions carry out their business activities with clients and investors, with the aim of facilitating the information flow between financial institutions and their clients.

11. **Other countries have found that separate independent agencies have served well their goals of financial stability and consumer protection.** Figure 2 represents a financial supervisory framework where insurance, banking, and securities supervision are all under separate and independent agencies. Examples of such a model include, among others, France and Italy. Other alternative organizational structures for insurance supervision that are frequently observed in emerging economies are not common among OECD countries —such as a single supervisor for insurance and banking, or insurance and securities.[5] A point to be taken into consideration is the close link between the Spanish insurance and banking business.

12. **The main objective of coordination and information sharing systems between supervisory agencies is to achieve effective and efficient consolidated supervision of financial conglomerates**—however, countries' arrangements differ substantially on this issue. For example, Switzerland's system of exchange of information and coordination, including on-site inspections, are generally based on informal arrangements. Other countries have chosen more formal arrangements. For example France has a joint body, the CACESF, comprising the chairmen of the central bank, the AMF, and the CCAMIP, within which these agencies can exchange information. Operationally, cooperation has been enhanced and formalized by a charter signed by the central bank and the CCAMIP. According to the BCP assessment this arrangement "[…] has provided a basis for coordinated on-site inspections in banking and insurance linked businesses" (IMF, 2004).

[4] In addition, the formulation and implementation of monetary policy—although less relevant for local central banks in the EMU context—requires a thorough understanding of financial markets and institutions.

[5] There are examples among OECD countries, however, of unified banking and securities supervision, for example in Luxembourg and Switzerland.

Figure 1. Alternative Models of Integrated Financial Supervision

Integrated Model 1 (UK)

<table>
<tr><th></th><th>Macro Prudential</th><th>Micro Prudential</th><th>Conduct of Business</th></tr>
<tr><td>Banks</td><td rowspan="3">Central Bank</td><td rowspan="3" colspan="2">Integrated Financial Supervisor</td></tr>
<tr><td>Securities</td></tr>
<tr><td>Insurance</td></tr>
</table>

Integrated Model 2 (Netherlands)

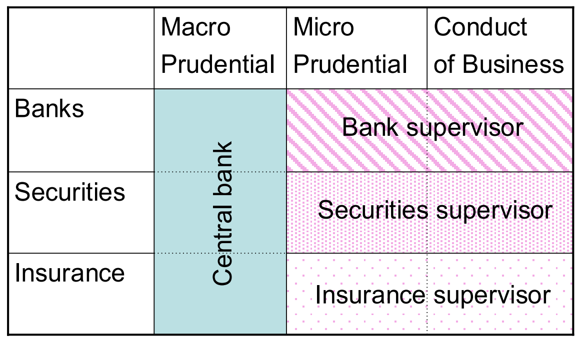
<table>
<tr><th></th><th>Macro Prudential</th><th>Micro Prudential</th><th>Conduct of Business</th></tr>
<tr><td>Banks</td><td rowspan="3" colspan="2">Central Bank</td><td rowspan="3">Integrated Financial Supervisor</td></tr>
<tr><td>Securities</td></tr>
<tr><td>Insurance</td></tr>
</table>

Integrated Model 3 (Australia)

<table>
<tr><th></th><th>Macro Prudential</th><th>Micro Prudential</th><th>Conduct of Business</th></tr>
<tr><td>Banks</td><td rowspan="3">Central Bank</td><td rowspan="3">Integrated Financial Supervisor</td><td rowspan="3">Integrated Disclosure/COB Supervisor</td></tr>
<tr><td>Securities</td></tr>
<tr><td>Insurance</td></tr>
</table>

Figure 2. Model of Separate Financial Supervision 1/

Separate Supervisory Agencies
(e.g. France and Italy)



1/ Note that there are no examples of joint supervision of insurance and banks (and separate securities supervision) or insurance and securities (and separate banking supervision) among OECD financial systems.

B. Recommendations

13. **The main recommendation is the separation of insurance supervision from Ministerio de Economía y Hacienda** to achieve greater operational, institutional, and budgetary independence. This note has presented various alternatives for an independent insurance supervisory agency, which are summarized in Figures 1 and 2. The evaluation of which of the models is most appropriate for Spain would need to take into consideration not only the synergies emerging from different alternatives, but also the transitional and operational costs involved.

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